No. 12,506

IN THE

United States Court of Appeals

For the Ninth Circuit

THE WESTERN PACIFIC RAILROAD CORPORATION and ALEXIS I. duP. BAYARD, Receiver,

Plaintiffs and Appellants,

and

MEREDITH H. METZGER, HENRY OFFERMAN and J. S. FARLEE & CO., INC., a corporation,

Interveners and Appellants,

vs.

THE WESTERN PACIFIC RAILROAD COMPANY, SACRAMENTO NORTHERN RAILWAY, TIDEWATER SOUTHERN RAILWAY, DEEP CREEK RAILROAD COMPANY, THE WESTERN REALTY COMPANY, THE STANDARD REALTY AND DEVELOPMENT COMPANY and DELTA FINANCE CO., LTD.,

Defendants and Appellees.

Opening Brief of Appellants The Western Pacific Railroad Corporation and Alexis I. duP. Bayard, Receiver

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SUBJECT INDEX

TABLE OF AUTHORITIES CITED

Pages

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TEXTS, TREATISES AND OTHER MATERIAL

CHRONOLOGY

(P. Ex. 2B)

1943		
March 15		Supreme Court approves Plan.
March 23		Coulson firm employed as Tax Counsel.
May	15	1942 tax returns filed.
June	1	All employees New York office taken over as full time employees of Trustees.
Oct.	11	District Court confirms Plan.
1944		
January		1943 tax accruals reversed. Coulson Opinion Letter.
April	30	Affiliation terminated.
July	15	1943 tax returns filed.
Dec.	14-29	Property revested in Company and Assumption Agreement executed.
1945		
March	9	Refund Claim 1942 taxes filed.
May	1	New York offices closed. Curry and Valouch go to Coulson's office.
June	15	1944 tax returns filed.
1946		
Oct.	10	This suit filed.
1947		
Feb.	11	First offer of tax settlement.
Aug.	13-26	Tax settlement with Government.

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JURISDICTION

This is an appeal from a final judgment of the District Court : the Northern District of California, Southern Division,

entered January 13, 1950 (324). Notice of appeal was filed February 8, 1950 (326).

The jurisdiction of the District Court was invoked under 28 U.S.C. Sec. 1332. Appellant The Western Pacific Railroad Corporation (plaintiff below) is a Delaware corporation, and the appellees (defendants below) are California corporations, except that The Western Realty Company and Deep Creek Railroad Company are respectively corporations of the States of Colorado and Utah (Complaint, 6; Answers, 12, 117, 118). The appellants Metzger, Offerman and Farlee were interveners below. They were stockholders of plaintiff, presenting no claims of their own and their interest is identical with that of plaintiff. Appellant Bayard, Receiver, is a citizen of Delaware and was appointed receiver by the Chancery Court of Delaware (292, 293).

The amount in controversy exceeds $3,000, exclusive of interest and costs (Complaint, 6; Supp. Complaint, 208-231).

The jurisdiction of this Court is invoked under 28 U.S.C 1291 and 1294(1).

STATEMENT OF THE CASE

I. Nature of the Case

In this action plaintiff The Western Pacific Railroad Corporation seeks to compel the principal defendant to account for a $17,201,739 federal tax benefit derived from the utilization by that defendant of a right belonging to plaintiff. This benefit was obtained by that defendant by causing consolidated income tax returns to be filed by plaintiff wherein a $75,000,000 loss incurred by the plaintiff was used to offset the defendant's taxable income As a consequence, taxes otherwise payable by the defendant were

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All emphasis is supplied unless otherwise indicated.

References to pages of the transcript are shown by the page number in parenthesis: ( ).

Exhibits are indicated thus: Plaintiff's (P); Defendants' (D), the number of the exhibit following the letter.

When the page of the record for an exhibit is given, it is shown by the page number preceding the letter indicating the party whose exhibit it is, with the number of the exhibit following the letter, thus: (P)

lischarged. The court below found the amount of the tax bene-it which defendant obtained by use of plaintiff's loss to be $17,-201,739 (267). For convenience, this will be referred to as $17,000,000.

The court entered judgment for the defendant without costs (323-325). It rendered an opinion (258) reported in 85 F. Supp. 868, which it adopted as its findings (319).

Until April 30, 1944, the plaintiff, for convenience called he Corporation, owned all of the capital stock of the principal efendant, The Western Pacific Railroad Company, an operating ailroad company, for convenience called the defendant or the Operating Company.[1] For this stock the plaintiff had invested 75,000,000 in the Operating Company (262).

In 1935, the Operating Company was in financial difficulties, nd went in bankruptcy under Section 77 of the Bankruptcy Act,[2] n proceedings in the court below (1908). Trustees were ap-ointed by the bankruptcy court in September, 1935 (1916), nd remained in possession until December 29, 1944 (see p. 26, ifra). The term "defendant" or "Operating Company" as used n this brief includes the trustees during that period.

In 1939, the Interstate Commerce Commission proposed and pproved a plan of reorganization. In this plan the Commission ound that the Corporation's stock in the Operating Company as without equity or value and was not entitled to participate the reorganization.[3] The bankruptcy court approved the Com-

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[1]Six additional defendants are named in the pleadings but for practical rposes may be ignored. Four were wholly owned subsidiary companies the Operating Company when the tax returns were filed, and all still cupy that status. Another, Western Realty Company, was wholly owned plaintiff. Its financial stake in this action cannot exceed $11,240. The venth defendant was wholly owned by Western Realty and is now holly owned by the Operating Company.

The corporate relationships of the parties are shown on a chart (P 1). inting of this exhibit in the record was dispensed with by order of this urt (2175), but it is reproduced at the end of this brief.

[2]11 U.S.C. 205.

[3]*Western Pacific R. Co. Reorganization,* 233 I.C.C. 409, 452.

mission plan (1666 P. 8). The Corporation appealed, and on November 28, 1941, this Court reversed the bankruptcy court.[4] On March 15, 1943, the Supreme Court reversed this Court and affirmed the bankruptcy court's approval of the plan.[5]

By this decision of the Supreme Court, on March 15, 1943, the $75,000,000 investment of the Corporation in the Operating Company was wiped out.

The Corporation had no other substantial assets, and on October 19, 1949, was placed in receivership in Delaware on petition of the Attorney General of that state (292). On motion of the Corporation (289), the receiver, Alexis I. duP. Bayard, was joined as a party plaintiff in the present case on November 28, 1949 and is one of the appellants (317).

The real parties in interest on the plaintiff's side are its 4,700 stockholders, living all over the United States, more than 1,000 of them in California (659). It was they who had invested $110,000,000 in its stock,[6] and it in turn had invested over $75,000,000 in the stock of the Operating Company.

Any recovery by plaintiff will go to the receiver for the benefit of plaintiff's preferred stockholders.[7]

At the request of the receiver, who joins in this brief, we attach as "Appendix Two" a copy of his preliminary report to the court that appointed him.

HOW THE TAX BENEFIT WAS OBTAINED.

The way in which the Operating Company obtained the $17,000,000 tax benefit from the use of the Corporation's loss of $75,000,000 was as follows:

Under the Internal Revenue Code,[8] a parent company and its

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[4] *In re Western Pacific R. Co.*, 124 F.2d 136 (9 Cir.).

[5] *Ecker v. Western Pacific R. Corp*, 318 U.S. 448.

[6] P 4B, Schedule C; this is one of the exhibits printing of which was dispensed with by order of this Court (2175).

[7] The preferred stock exceeds the amount recoverable in this suit (1717).

[8] Internal Revenue Code, Sec. 141; Treasury Regulation 104, relative to income taxes, and Regulation 110, relative to excess profits taxes.

subsidiaries may file a single consolidated tax return in which losses are offset against gains, and taxes are paid only on the net. By an amendment made in October 1942, a loss due to a stock's becoming worthless could be treated as an operating loss, instead of a capital loss as theretofore, and offset against ordinary income.[9]

By the decision of the Supreme Court on March 15, 1943, the Corporation sustained a $75,000,000 loss. But at the very instant the Corporation sustained this loss, its financial interest in the Operating Company terminated, and it became a complete economic stranger.

In this state of facts tax counsel of the Operating Company conceived the plan of having the Corporation and Operating Company file consolidated returns in order to set off the Corporation's loss against the Operating Company's income.

This the Operating Company caused to be done.

The Operating Company made large profits in the war years of 1942, 1943 and 1944, at which time the excess profits tax was in effect. Taxable net profits were nearly $11,000,000 in 1942, over $18,000,000 in 1943, and in 1944 up to April 30th nearly $3,000,000 (P 3, 4, 5). And throughout 1943 and the first four months of 1944 moneys were accrued by the Operating Company to meet the expected tax liability in an amount exceeding $10,500,000 (915 P 56, 1818-1824 P 76).

Consolidated income and excess profits tax returns for 1943 were filed in the Corporation's name on July 15, 1944 (P 4A and 3). They reported the Corporation's huge stock loss sustained in 1943, used $18,000,000 of it to offset that amount of taxable net income of the Operating Company, and thus reported no net income and no tax due.

The unused portion of the loss could be carried forward and back (I.R.C., Sec. 122(b)(1) and (2)). On March 9, 1945, defendant's tax counsel filed a claim for refund in the name of

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[9]Revenue Act of 1942, Sec. 123(a), adding subsection 4 to Section 3(g), I.R.C.

the Corporation to recover the $4,201,821 paid for the defendant's 1942 taxes (1656, P 6), the basis of the claim being the use as a carryback of over $10,000,000 of the unused portion of the Corporation's 1943 loss. And on June 15, 1945, defendant's tax counsel filed consolidated returns in the name of the Corporation for the period January 1-April 30, 1944 (P 5A, 5B), offsetting against nearly $3,000,000 of income of the Operating Company another portion of the Corporation's loss, and no income and no tax due were reported.

In 1947, the taxes were finally settled by agreement with the Treasury Department on the basis of the returns as filed, the 1943 and 1944 taxes being nil, and the claim for refund for 1942 being rejected (see further detail at pp. 20-23, infra). The net savings retained by the Operating Company due to the use of the Corporation's stock loss were, as found by the court below, $17,201,739 (267).

It is of these savings, obtained through the use of the Corporation's stock loss, that the Corporation seeks an accounting.

The question before this Court is whether the Corporation, and its stockholders who provided the capital which was lost, are entitled to the benefit obtained by the Operating Company through its use of that loss.

THE DATE OF LOSS, AND THE ECONOMIC SEVERANCE.

Following the Supreme Court's decision on March 15, 1943, the Reorganization Plan was confirmed by the Bankruptcy Court on October 11, 1943 (1674 P 10). The economic unity which had previously existed between the Corporation and the Operating Company was severed forever, and they became economic strangers. The proprietary interest of the Corporation in Operating Company was at an end; the community of economic interest was over.

But for all practical purposes the Supreme Court's decision marks the date of the loss. It then became the duty of the District Court (in the absence of some unusual circumstances) to confirm the plan if the requisite percentage of creditors should

vote in favor of it and probably even if they did not.[10] The James Interests, the largest stock interest in both the Corporation and the Operating Company (1717 P 17, 18), had previously fought the Plan and sought to maintain the Corporation's equity in the Operating Company.[11] But immediately after the Supreme Court's decision the James Interests decided to support the Plan and entered into an agreement with other major creditors to work wholeheartedly for its prompt consummation (577, 578, 618).

For income tax purposes it is irrelevant whether the date of plaintiff's loss is March or October, 1943, for in either event it is a 1943 loss. For the purpose of fixing the relative rights, duties and obligations of the parties, the date of March 15, 1943 (the Supreme Court decision) is important. Before then the Corporation as the owner of all of the stock of the Operating Company, and as the hopeful petitioner for the continuance of that ownership after reorganization, was benefited by any benefit that accrued to the Operating Company. After the Supreme Court decision, everyone having to do with the affairs of the Corporation was under the highest obligation to see that its rights, and the rights of its stockholders, were not dissipated, lost, violated or neglected. From that date those persons who, with propriety, had heretofore acted in dual capacities or as joint officers of the Corporation and Operating Company were now under the highest obligation to see that no act and no inaction of theirs should prejudice the rights of either company against the other.

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[10] Bankruptcy Act, Sec. 77(e); 11 U.S.C. Sec. 205(e).

[11] For the identity of the James Interests, cf. p. 13, infra, and chart, 1, reproduced at the end of this brief.

II. The Operating Company Conceived the Tax Saving, Took Over and Handled the Tax Affairs of Plaintiff Corporation, Appropriated Plaintiff's Tax Credits in Order to Accomplish the Tax Saving, and Ignored Its Fiduciary Relation to Plaintiff in Refusing to Account.

The foregoing are the bare facts showing how the Operating Company received a benefit of $17,000,000 through the use of the plaintiff's loss. Under principles to be hereafter discussed, these facts, without more, entitle plaintiff to judgment.

But beyond that, the manner in which the transaction was handled, the relationship of the parties, and the resulting duties and obligations, not only fortify the plaintiff's claim but furnish an independent ground of recovery.

As we now proceed to show, the taxes were saved through a method conceived, planned and executed by the Operating Company by agents occupying a fiduciary relation to the Corporation, without consideration of any rights of the Corporation and its stockholders and in disregard of their fiduciary obligations.

FINDINGS.

The court below found:

> "* * * in 1943, after the filing of the 1942 return and payment of the tax, *the tax attorneys for defendant* 'discovered' Section 123 of the Revenue Act of 1942. (26 USC 23(g) 4). They proposed what they denoted a 'paradoxical' theory, by which the worthlessness of the plaintiff's stock (which had cost the plaintiff some $75,000,000) in the operating railroad company (debtor), might be availed of as an offset to the operating income of the debtor and thus result in a net loss and no tax obligation." (261, 262)

And again:

> "* * * the tax attorneys caused the filing of consolidated tax returns for 1943 and for the forepart of 1944 in the name of plaintiff, in which sufficient portions of the $75,000,000 stock loss were used as offsets against the operating accounts for these years, so as to show no net income." (262)

"* * * *the tax attorneys for the defendant* conceived a 'paradoxical' plan. *They decided* that *they would* file, * * * consolidated returns on behalf of the parent company and its subsidiaries and in them set up the plaintiff's stock loss * * * as an income tax deduction against the operating profits." (265, 266)

And:

"On December 17, 1947, plaintiff filed a supplementary bill of complaint * * * It was there further alleged that the defendant through its officers and attorneys had controlled the board of directors of the plaintiff corporation and that by reason of such control plaintiff was caused to file the consolidated returns for the benefit of the defendant. Throughout the proceedings and in the trial, this has been referred to as 'duality of control'." (264)

And:

"* * * there is a preponderance of the evidence in favor of the plaintiff's contention of 'duality of control'." (272)

The court later, in the course of settling the findings, showed what it meant. It said, "There is no question about it" in response to the assertion that,

"* * * the evidence certainly discloses that the tax operations, however they may be characterized, were conducted *by the defendant and its tax counsel, not by the plaintiff.*" (468)

SUMMARY OF THE FACTS.

Under the law and the Treasury regulations concerning consolidated returns, the returns must be filed in the name of the parent corporation, claims for refund are filed in its name, and all refunds are payable to it.

The defendant used the plaintiff Corporation for its purposes. The facts are fully stated below; in summary, they are these.

The defendant Operating Company employed one Polk and the firm of which he was a partner, Whitman, Ransome, Coulson and Goetz, as its tax attorneys. Polk conceived the plan of using

plaintiff's loss to cancel the defendant's tax liability. He convinced the defendant of the possibility of success of his plan and obtained its authority to proceed.

Plaintiff was in an impoverished condition following the Supreme Court decision of March 15, 1943. It could no longer pay its officers' salaries or office rent. Its officers were taken over as "full time employees" by the defendant on July 1, 1943, before the tax returns were filed, and continued as such until May 1, 1945, when Mr. Curry, the president of plaintiff, moved to Polk's office to be available for these tax matters, ostensibly as an employee of Polk's firm but actually compensated by defendant.

Polk, pursuant to his plan, used these officers to file consolidated tax returns in plaintiff's name, and he caused its loss to be offset against defendant's income. He obtained through Curry a power of attorney from plaintiff. Without the knowledge of plaintiff, but only after specific authorization of defendant, he made an offer of settlement to the Treasury in the name of plaintiff which was finally carried through. He was employed, directed and compensated solely by the defendant, and never gave plaintiff any advice as to its rights.

THE PLAINTIFF'S STUNNED CONDITION.

The plain fact is that the defendant, and Polk and all connected with the transaction, considered plaintiff a defunct and dying corporation and gave no consideration whatever to its rights.

After the Supreme Court decision of March 15, 1943, the plaintiff Corporation was, to select an appropriate metaphor, in a state of coma, stunned by the misfortunes heaped upon it. It had lost its chief asset, its $75,000,000 investment in the Operating Company. Its other assets were pledged to secure loans then in default (571-573 P 47; also 1767, 1768, 1695-98). Consequently in March 1943, plaintiff's directors were contemplating dissolution and so advised its chief creditors, including the James In

terests (571 P 47). The James Interests would be the controlling interest in the reorganized Operating Company (Corporate Relationship Chart, P 1), and they were represented by Mr. Coulson, Polk's partner (see p. 13. infra).

The plaintiff's Delaware franchise taxes were in default, but Polk considered it essential that it remain in existence until the reorganization was consummated (1764 P 5). Funds to pay these taxes were then provided by the James Interests (713).

PLAINTIFF'S LACK OF INDEPENDENT REPRESENTATION:—
DUALITY AND THE DUALITY CHART.

The positions occupied during the critical period by those who were directors or officers of the Corporation and the Operating Company are shown by plaintiff's Exhibit 2A. Printing of this exhibit in the record was dispensed with by order of this Court (2175), but we reproduce it at the end of this brief. It will be referred to, from time to time, as the "duality chart."

Prior to June 1, 1943, plaintiff had maintained its offices jointly with those of the Operating Company and the Trustees in New York. Its officers were also employees of the Operating Company, and their salaries and the expenses of the office had been jointly paid.

But plaintiff's impoverished financial condition necessitated a change. As of June 1, 1943, the Corporation was incapable of further paying salaries or office expenses. Thereupon all of the officers and employees of the New York office, including the president and secretary of the plaintiff, were taken over by the defendant by decision of its president, and in his words became its "full time" employees (1738). This situation continued until the Operating Company closed its New York offices on May 1, 1945, when plaintiff Corporation's president and secretary were taken over by defendant's tax counsel and thenceforth received their compensation from them, which compensation was ultimately paid by defendant. (1735, 1738)

From June 1, 1943, until this suit was filed in October 1946, nine persons were at one time or another directors of the plaintiff Corporation. With only three exceptions (Messrs. Osborn, Wood and Hatton), every one of them was an employee of the defendant Operating Company from which they received their livelihood, and one of them (Mr. Schumacher) was not only a director and Chairman of the Company's Executive Committee but was also one of its trustees in bankruptcy.

Of the three who were not employees of the Operating Company and who did not receive any compensation from it, one of them, Mr. Osborn, was a director of the Operating Company and another, Mr. Hatton, was a clerk in the employ of the Denver & Rio Grande Western Railroad and as such recognized Mr. Schumacher as his superior and chief, for Mr. Schumacher was an officer of that company (1135). Three of the nine were mere clerks in the defendant's employ—Miss Sheehan, switchboard operator; Mr. Wienken, stenographer; Miss Valouch, stenographer and clerk. Miss Sheehan and Mr. Hatton were put on the board merely to make up a quorum (1138, 1139), and Miss Valouch did not become a director until the day the New York office was closed, when she became a regular employee of defendant's tax counsel.

Of this whole group of directors, none—other than Mr. Wood and Mr. Osborn—had the capacity, business experience or financial independence of the Operating Company to give competent attention to plaintiff's affairs in any matter wherein the Operating Company could have an adverse interest. Yet, as Mr. Wood and Mr. Osborn testified, not until shortly before the present suit was filed in October 1946, did either ever know or was either advised that the plaintiff's stock loss was being used in tax returns or that thereby defendant was saving taxes; neither knew or was advised of the legal or economic consequences of the filing of the returns involved in this case (Wood, 1129, 1132; Osborn, 1019, 1022).

Meanwhile, plaintiff Corporation had, actually, only one officer, Mr. Curry. Mr. Curry was a competent chief clerk, and he so re-

garded himself (639, 646, 647, 736, 756). When Mr. Schumacher retired as president of the Corporation, in part because of advanced age but primarily because of plaintiff's financial distress (644, 645, 743), there was "nothing facing us but liquidation and dissolution * * * he [Schumacher] felt I [Curry] could carry through", and Mr. Curry was therefore, on February 1, 1942, appointed president and treasurer (743). He was, at the same time, an employee of the defendant Operating Company, its vice president, assistant secretary, assistant treasurer, a director and a member of its executive committee.

After June 1, 1943, although Mr. Curry continued as the plaintiff Corporation's president, he received no compensation from it (645) and thereafter received his livelihood from the defendant Operating Company until May 1, 1945 (1729 P 27) when he went on a pension from the defendant (530, 532) and a retainer from its tax counsel at its ultimate expense (1744 P 32A; 1749 P 42). He did not consider that he had any understanding of, or competence in, tax matters and relied implicitly on tax counsel. "Tax matters were wholly Greek to me," testified Mr. Curry (808).

MESSRS. COULSON AND POLK.

A description of what was done requires an identification of Mr. Coulson and his partner, Mr. Polk, and of the James Interests.

From 1925 until his death in 1941, Mr. Arthur Curtiss James and his wholly owned companies owned 8.8% of the Corporation's preferred stock and 61% of its common stock (Chart, P 1). Mr. Coulson and his firm (Whitman, Ransome, Coulson and Goetz of New York) were attorneys for Mr. James and his companies and were and are attorneys for all the James Interests, including the James Foundation of which he is a trustee (536).

James died in 1941, and after the Supreme Court's decision on March 15, 1943, upholding the Plan of Reorganization, Mr. Coulson and the James Interests decided to cast their lot with the Op-

erating Company, although as a major creditor they could still have voted against the Plan (577, 578).[12]

The common stockholdings of the James group in the Corporation became worthless when the Plan was approved by the Supreme Court. On the other hand, their securities gave them a large interest in the reorganized Operating Company, for they were to receive under the Reorganization Plan 28% of the stock in that Company (Chart, P 1).

MR. COULSON INTRODUCED HIMSELF INTO THE PARTIES' TAX MATTERS, FEBRUARY 1943, AND HIS FIRM BECAME TAX COUNSEL FOR THE DEFENDANT MARCH 1943.

On February 24, 1943, three weeks before the Supreme Court's decision, when his firm was not tax counsel for either plaintiff or defendant, Mr. Coulson introduced himself into their federal tax matters on behalf of the James Interests, by writing Mr. Elsey, president of the Operating Company, asking for information about its tax matters (537 P 37). He was disturbed by the reply, believing Mr. Elsey evasive or not competently looking after taxes. On March 15th, the day of the Supreme Court's decision, he asked his partner, Mr. Polk, by memorandum, to look into the situation, stating (539 P 38):

> "Actually, I happen to know that the only person over at the Corporation office here in New York who has any knowledge of taxes is a girl who is primarily Schumacher's Secretary * * * I would be a little surprised if the report were intelligently prepared."

Polk replied that "Only the lady referred to had any part in the preparation of the return * * *. Mr. Curry says they are too impoverished to hire accounting help." (540 P 38A)

Eight days later, on March 23, 1943, Mr. Coulson and his firm became tax counsel for the Trustees and the defendant Operat-

[12]Mr. James' allegiance during his lifetime lay with the Corporation; he sought to save the Corporation's equity in the Operating Company and was active in resisting the Plan of Reorganization of the Interstate Commerce Commission which denied this equity (536).

ing Company, and the actual work was delegated to Mr. Coulson's law partner, Polk, who specialized in tax matters. (543 P 39A-D)

Messrs. Coulson and Polk and their firm obtained all their compensation and received all their instructions from the defendant Operating Company,[13] but they conducted themselves as attorneys at law and attorneys-in-fact for plaintiff Corporation as well.

In view of the Corporation's misfortune and its stricken condition, it was the high fiduciary duty of its agents to be diligent to protect its rights, to utilize every opportunity that might retrieve something for its stockholders from the debacle, above all not to permit the use of the Corporation's rights, including its stock loss, for the benefit of another, without accounting.

THE PLAINTIFF CORPORATION WAS UNDER NO DUTY TO FILE CONSOLIDATED RETURNS.

Under the law and the regulations, only the parent corporation can file consolidated returns (Reg. 104, Sec. 23.16(a)). The fact that a consolidated return has been filed in one year gives rise to no duty or obligation to file such a return in a subsequent year, if the law or regulations have been so changed as to make it less advantageous (Reg. 104, Sec. 23.11(a)). In that case separate returns may be filed.

Each of the years 1942, 1943 and 1944 was one in which any member of an affiliated group was free to file separate returns, irrespective of whether consolidated returns had been previously filed (II Montgomery's Federal Taxes, Corporations and Partnerships, 1946-7, p. 649, 650). And at the time each return in question here was filed, there existed the right in the plaintiff Corpo-

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[13]On November 15, 1948, Coulson rendered a final statement to the defendant "covering professional services in the tax disputes as to the taxable period January 1, 1942 through April 30, 1944" in the amount of $300,000. At the same time he also rendered a bill to defendant for the retainer payments to Curry, plaintiff's president, for the period July 1, 1945 to December 31, 1948, in the amount of $10,500 (1749 P 42).

ration not to file a consolidated return if it was so advised. Unless the defendant Operating Company could become a party to consolidated returns with plaintiff, it would have to file or pay taxes on the basis of separate returns. Mr. Polk was aware of these facts (1458).

Prior to the Supreme Court's decision tentative returns on a consolidated basis had been filed for 1942 and an extension obtained until May 15, 1943 for the final returns. Under the regulations, the filing of a tentative consolidated return did not preclude filing the final returns on a separate basis. (Reg. 104, Sec. 23.10(b)). Whether the final return should be a consolidated one was one of the first questions considered by Mr. Polk (543 P 39A). And the severance of the economic unity between plaintiff and defendant which took place between the filing of the tentative returns and the filing of the final returns presented a wholly new considation.

1942 TAX RETURNS.

Without calling any of these factors to plaintiff's attention, Mr. Polk decided that it was in the interest of the defendant Operating Company that consolidated returns should be filed (Polk, 1444, Coulson, 1482). He had these returns prepared and had them placed before Mr. Curry, vice president of the Operating Company and president of the plaintiff Corporation, for signature. Mr. Curry had been informed by Mr. Schumacher that Mr. Polk was tax counsel for the Operating Company and the Corporation (660). When the returns were laid before him for signature, he therefore inquired whether they had Mr. Polk's approval. Being informed that they had, he signed without consulting or advising the Corporation's board of directors and without being advised by Mr. Polk or anyone else that plaintiff Corporation did not have to file consolidated returns (663, 664).

THE 1943 RETURNS: THE DECISION TO USE PLAINTIFF'S STOCK LOSS WAS MADE BY DEFENDANT.

The idea of using the Corporation's stock loss occurred to Mr. Polk in May 1943. In a letter to Mr. Curry as vice president of the Operating Company, on May 20, 1943, he stated it to be a mere speculation of a possibility and was "commented on rather that suggested * * * since it is paradoxical" ("paradox letter," 588 P 50). Polk sent no advice of it to the Corporation.

In December 1943, Mr. Polk first decided to make use of the plaintiff's stock loss (Polk, 1448; Coulson, 1484). When he came to that conclusion, he did not advise plaintiff or Mr. Curry. Instead, he went to San Francisco to discuss the tax matters with defendant Operating Company's officers, the agents of the reorganization trustees, and in January 1944 he recommended to them the filing of consolidated returns and the use of plaintiff's loss (1448, 1484), although he refused to advise that the defendant Operating Company could "bank" on the Treasury's allowing the deduction.[14] Without advising or consulting plaintiff, he told Mr. Elsey, defendant's president, that "We [the Company] were within our legal rights in taking the Corporation's stock loss as a deduction in our consolidated return" (Elsey, 1268).

The decision to use the plaintiff's loss was made in San Francisco by Mr. Elsey, president of the defendant Operating Company, in January 1944 (1448, 1484). Mr. Elsey insisted on a written opinion to protect him (1268), and such an opinion, dated January 11, 1944, signed by Mr. Coulson, was addressed to him as president of the Operating Company. Although plaintiff Corporation was not consulted, the opinion stated flatly,

> "Accordingly, there will be allowed in the consolidated return a loss to the parent company of approximately the cost

[14]Mr. Elsey, president of the Operating Company, testified that (1268) "Mr. Polk advised me that we were within our legal right in taking the Corporation's stock loss as a deduction in our consolidated return. * * * I was very much surprised at that statement, and asked him if I could bank on it. He said no, that that matter will not be finally decided until the Treasury Department completes their audit on our '43 returns." Note that in this conversation the plaintiff's loss is treated as though it belonged to the defendant.

> of the Railroad Company stock. This loss however computed would appear to far exceed the incomes of the other members of the affiliated group. Accordingly, for the year 1943 on a consolidated return basis there would appear to be no excess profit tax or income tax liability." (605 at 609, 610 P 54).

Mr. Elsey sent a copy of this letter to Mr. Schumacher as one of the defendant's Trustees (613, 614). But no one sent a copy to the plaintiff Corporation or advised it (665). In the Operating Company's annual report for 1943, issued under date of May 1, 1944, 2½ months before the returns for 1943 were filed, it inserted a statement that "A consolidated tax return for 1943 can and will be filed by the holding company" (512). This determination that the plaintiff "will" file a consolidated return was not made by the plaintiff but by the defendant and without consultation with the plaintiff. The decision was made in Mr. Elsey's office (1277, 1278, 1450).

In due course the 1943 returns were prepared under Mr. Polk's direction and were laid before Mr. Curry for signature as president of the Corporation. Mr. Curry had had no part in their preparation, but, being assured that Mr. Polk approved them, he signed, again without consulting the Corporation's board of directors and without being advised that the Corporation need not file a consolidated return if it did not wish to do so (663-665).

1942 REFUND CLAIM BASED ON CARRY-BACK OF PLAINTIFF'S LOSS.

In March 1945, the claim for refund of 1942 taxes based on the carryback of the Corporation's loss was prepared by Mr. Polk on his own initiative and without discussing it with any representative of the Corporation. Mr. Polk sent it to Mr. Curry with the request that he sign it as president of the Corporation (1418, 1450, 1451), and Mr. Curry, being told that Mr. Polk wanted him to sign, did so, again without consulting the Corporation's board of directors (667).

1944 TAX RETURNS:—MR. CURRY IN MR. COULSON'S OFFICE.

Late in 1944, Mr. Polk decided to recommend consolidated returns for the first four months of 1944 (the technical affiliation ended April 30, 1944), again using the plaintiff's loss (1486), and advised the defendant (623). But plaintiff was not advised about this decision. Mr. Polk testified that the decision to file such consolidated returns was made by the defendant Operating Company (1450).

These returns were not filed until June 1945. By that time Mr. Curry was occupying office space with Mr. Coulson's firm. On May 1, 1945, the New York offices of the Operating Company had been closed and all employees let out. On April 21, 1945, in anticipation of that event, Mr. Coulson wrote the president of the defendant to obtain approval of Coulson's retaining Mr. Curry at $3000 per year; he wished to hire the president of the plaintiff for the purpose of serving the defendant Operating Company's interests in the tax matters here involved (1496). He wrote,

> "As president of the old holding Company, which is a party in interest (without financial stake) in the consolidated return period, it seems to us essential that we have Mr. Curry available to secure us necessary data from the files of the holding company [i.e., plaintiff Corporation]" (1743 P 32).

Mr. Coulson did not advise the plaintiff Corporation that it had no financial stake in the consolidated returns, nor did he advise plaintiff of his purpose in taking Mr. Curry on this retainer. Mr. Curry's retainer was approved by the defendant.

On June 1, 1945, Mr. Curry, together with the Corporation's files, moved to Mr. Coulson's office. There he remained until September 10, 1948, when, after the statute of limitations had run against any tax deficiency claim (see p. 23, infra), Mr. Coulson requested him to vacate (656). For 3½ years while in Mr. Coulson's office, Mr. Curry received $3000 per year from Mr. Coulson's firm, for which it eventually billed the defendant Operating Company (1749 P 42). The only services which Mr.

Curry performed for his retainer was to sign the 1944 tax return and execute as president of the Corporation a power of attorney in its name in favor of Polk (657-8).

The return for the first four months of 1944 was filed June 15, 1945. It was prepared in Mr. Polk's office and brought to Mr. Curry, who occupied a room a short distance down the hall from Mr. Polk (1442), to sign (1418). When Mr. Curry first moved to Coulson's office, he was told by Mr. Coulson that "he was to put himself at Mr. Polk's disposal in connection with the consolidated return" (Coulson, 1498). When told that Mr. Polk wanted him to sign in the 1944 return, he signed, again without consultation with his board of directors and without being advised that the Corporation need not file a consolidated return if it did not wish to do so (666).

THE POWER OF ATTORNEY AND THE SETTLEMENT WITH THE GOVERNMENT.

The extent to which the plaintiff was disregarded, and the extent to which the defendant took over the tax affairs of the plaintiff, is illuminated by the manner in which the tax settlement with the government was carried out. All negotiations for settlement with the government were conducted by Mr. Polk in the plaintiff Corporation's name but without its knowledge (Polk, 1451).

On May 31, 1946, Mr. Polk wrote to the Internal Revenue Agent in Charge, justifying the use of the Corporation's loss ("first Krigbaum letter", 1779 P 64), but he never, at any time, advised the Corporation or Mr. Curry of that letter (Polk, 1443; Curry, 667).

Since the government recognizes only the parent corporation in consolidated returns, it then became necessary for Mr. Polk to obtain a power of attorney from the Corporation to continue settlement negotiations. On June 26, 1946, Mr. Polk prepared such a power of attorney running to himself (1784 P 65) and sent it in to Mr. Curry to sign. Mr. Curry signed and he did sc

without consulting his board of directors because he was told that Mr. Polk wanted it. (Curry, 668). Thereafter, Mr. Polk "conducted all the negotiations in the name of the plaintiff Corporation under [this] power of attorney" (Polk, 1442, 1451).

On February 11, 1947, Mr. Polk wrote to the Commissioner of Internal Revenue ("Nunan letter" 1662 P 7). This was the offer of settlement that was accepted by the government in August 1947. It was made and signed in plaintiff's name by Mr. Polk; yet he showed no copy to the plaintiff or to Mr. Curry, sent no copy to them, and did not even advise them what was going on until April 1947, although during that period Mr. Curry was occupying a room in the Coulson suite not 50 feet away from Mr. Polk's office (Polk, 1442; Curry, 654), and despite the fact that the present action had been filed by plaintiff against defendant in the previous October.

While ignoring the plaintiff, Messrs. Polk and Coulson were meticulous in obtaining authority from the *defendant* to make the offer of settlement in the name of the *plaintiff.* Mr. Polk, in Washington negotiating with the Treasury, telephoned Mr. Coulson in San Francisco to secure defendant's authority to make the offer. Mr. Coulson and Mr. Elsey, president of the defendant, agreed that this would require authorization by *its* directors (Elsey, 1283, 1284). It was only after the defendant's directors had been polled and approved the offer that Polk delivered the offer in settlement (Coulson, 1494; Polk, 1430). This may be contrasted with Polk's action in writing and delivering the offer in plaintiff's name and under its power of attorney, not only without consulting the plaintiff, but without informing it until two months later.

The reason assigned by Mr. Polk on the witness stand for ignoring the plaintiff in the settlement negotiations was that he supposed "my responsibility was to them [the Company] and not the Corporation" (1431), although the offer was made in the name of the Corporation and not of the Operating Company. However, "I knew of the pending litigation," and finally it

dawned upon him that his conception of his duty was peculiar, and "I came to the conclusion that they should be notified" (1431). Mr. Polk was in San Francisco conferring about this case with the defendant's attorneys when this revelation came upon him; he telephoned to his New York office to send out a letter over his signature to Mr. Curry as president of the Corporation, and this was done on April 2, 1947 (1461, 1787 P 68).

Therein he requested the Corporation's approval of the offer of settlement. Mr. Curry referred it to the plaintiff's board of directors and not until then did the board know that Mr. Curry had signed a power of attorney (1023). The board caused a reply to be sent to Mr. Polk on May 5, 1947 (1794 P 69), wherein it said:

> "Although we wish to be entirely cooperative in this matter, the Corporation finds itself embarrassed by the action of the Western Pacific Railroad Company in opposing judicial settlement of the allocations of tax benefits, if any, derived from the application of the capital losses of the Corporation for the benefit of the Group. The Railroad Company's pleadings that the Railroad Corporation should be denied its day in court by reason of the statute of limitations and the District Court's injunctive order in reorganization does not invite the kind of cooperation from the Railroad Corporation that a settlement of the tax case, so ably and fairly proposed by you as counsel for both the Railroad Company and the Railroad Corporation requires. Had there been any question of the Railroad Corporation's right to a determination of the question of allocations of tax benefits, we feel sure that counsel representing both the Railroad Company and the Railroad Corporation would have specifically stipulated, at the time of the filing of the consolidated returns, for such allocation to be determined by the court, if the parties found themselves unable to agree thereto. Inasmuch as in the proposed settlement the Railroad Corporation foregoes its refund claim of $4,200,000, we think it appropriate that a stipulation promptly be entered into between the Railroad Company and the Railroad Corporation, and the other members of the Group, which will insure the Corporation its day in court for a settlement

of the questions of proper and equitable allocations of tax savings, if any, as well as fixing the amount of the refund as the basis for such savings.

"We trust you will use your good offices, representing both parties in this situation, to secure the approval of the Railroad Company to such a stipulation."

In the meanwhile, on May 6th, Mr. Polk again wrote to the Corporation, requesting approval of the offer of settlement (1797 P 70). But on that very day, without awaiting a reply and knowing that the plaintiff's request of May 5th had not been met, Mr. Polk renewed the offer of settlement, in plaintiff's name, in a conference with Treasury officials, and confirmed that renewal in the so-called "Second Krigbaum letter" of May 19, 1947 (1799 P 71). He signed that letter in the name of the plaintiff, and in it he asserted that "The taxpayer [i.e., plaintiff] on behalf of itself and its affiliated subsidiaries agrees to settle and determine the tax liabilities of said Corporation for the taxable years 1942, 1943 and 1944 in the amounts shown on the returns as filed," although the plaintiff had not yet given him the authority requested in his etter of May 6th. Mr. Polk never informed plaintiff of this "Second Krigbaum letter" (Polk, 1443), and Curry never heard of t until the trial (681).

Polk's offer of settlement to the Treasury was that the tax reurns be accepted as filed, the 1943 and 1944 returns showing no ax, and the claim for refund of the 1942 tax be rejected (171). This offer was accepted by the Treasury on August 13, 1947, 174) and the claim for refund was formally rejected on August 6, 1947 (175).

This settlement could have been repudiated by either party *Botany Worsted Mills v. United States*, 278 U.S. 282), but was ot, and the tax saving became certain and final for the first time n June 30, 1948, when the statute of limitations ran against any eficiency assessment (1751 P 42).

COULSON AND POLK NEVER ADVISED PLAINTIFF OF ITS RIGHTS.

At no time did Mr. Coulson or Mr. Polk give any advice to any officer of plaintiff Corporation as to what its rights might be against any other member of the group arising out of the filing of consolidated returns or the use of the plaintiff's stock loss, or advise the plaintiff that it was free not to file consolidated returns, although they knew that to be true (Polk, 1451-1458).

PLAINTIFF LEARNS OF THE USE OF ITS STOCK LOSS AND FILES THIS SUIT IN 1946.

In June 1946, a stockholder's bill was filed in New York by certain of the plaintiff's stockholders. By reason of that suit plaintiff's board of directors first learned of the use of plaintiff's stock loss in consolidated returns to the advantage of the defendant Operating Company (1024). This suit was filed in October 1946.

STIPULATION OF AUGUST 1947, PRETRIAL ORDER, AND SUPPLEMENTAL COMPLAINT.

Settlement with the government had not yet been effected when this suit was commenced.

The plaintiff was concerned that the form of the settlement should not prejudice its rights. Under the law and regulations, any refund under the claim of refund for 1942 taxes would be paid to plaintiff (Reg. 104, Sec. 23.16(a)). But the form of the proposed settlement called for rejection of the claim for refund and would thus leave defendant in possession of all the tax savings (see p. 23, supra).

Plaintiff therefore negotiated with the defendant for a stipulation to protect it. Before it was executed, the interveners in this case became fearful that it did not adequately protect the plaintiff's rights, and they applied to the court below for relief. After proceedings in open court (335-399), the court made a pretrial order on the subject (163). That order construed the stipulation and, so construed, made it binding for all purposes of the case.

Upon the basis of that pretrial order, the parties executed and filed the stipulation herein on September 3, 1947 (168-176).

The effect of the pretrial order was to distribute the tax saving of $17,000,000 over the three-year period, attributing $3,385,290 to 1942. In short, the claim for refund was not to be deemed to ıave been abandoned but to be diminished in proportion to the diminution of the entire tax savings, and placed in the same status ıs if it had actually been refunded and paid by the government o the plaintiff Corporation and by it paid into court to await udgment.

In December 1947, plaintiff filed its supplemental complaint (208, 231).

III. Other Relevant Facts

RANSMUTATION OF THE DEFENDANT OPERATING COMPANY.

The defendant is the same legal entity in which the Corporaion made its original investment of $75,000,000, but it has enirely different owners. When it went into bankruptcy in 1935 s the debtor, its properties passed into the control of bankıptcy trustees (1916). But the actual railroad operations connued without interruption in the name and under the direction f the defendant Operating Company's officers.[15]

The Reorganization Plan provided that it could be carried out ither by revesting the properties (then under the control of the ustees) in the Operating Company, or transferring the propties to a new corporation formed for the purpose (233 I.C.C. 53). Mr. Coulson, a member of the Reorganization Committee, ıought the benefits of using the old Operating Company's corpote shell were so substantial that he sought a contractual transr to the Reorganization Committee by the Corporation of its ock in the Operating Company (621). Otherwise, a new comıny would have had to be formed in order to wipe out the stock eld by the Corporation, as directed by the Plan.

Accordingly, the Reorganization Committee negotiated a conıct dated November 22, 1943, with the Corporation and cer-

[15]The court order provided that the "business shall be conducted in the me of the debtor by its regularly elected or appointed corporate officers, ents and employees, but under and subject to the direction of said ustees" (1921).

tain of its creditors, whereby the Corporation agreed to transfer the shares to the Committee or its nominee. On December 17, 1943, the Bankruptcy Court approved the "use of the debtor company" in carrying out the Plan (1930), and on April 30, 1944, the stock was transferred by the Corporation to the Reorganization Committee (Chart, P 1).

Thus the affiliation for income tax purposes between the Corporation and the Operating Company did not cease until April 30, 1944. The affiliation continued until then because ownership by plaintiff of defendant's stock continued until that date. But the economic unity, or community of economic interest, had ceased for all time in 1943 (see pp. 6. 7, supra), because the right to share economically in defendant by virtue of proprietorship had ceased in 1943; the technical ownership of the stock had become worthless.

CONSUMMATION OF THE REORGANIZATION.

Following the confirmation of the Reorganization Plan in October 1943, the steps necessary to consummate the reorganization were taken in due course. In November 1944 the Bankrutpcy Court made its revesting order (36). Pursuant to that order and on December 29, 1944, the operating properties were turned back to the Operating Company by Trustees' Deed, and, under date of December 14, 1944, the Operating Company executed an Assumption Agreement assuming, among other liabilities, "all outstanding current liabilities and obligations incurred by said Trustees * * * arising out of the possession, use, or operation of the debtor's properties by said Trustees, or their conduct of the debtor's business * * *" (1711, 1713).

It will be seen that the tax returns for 1943 and 1944 and th claim of refund for 1942 taxes were all filed *after* the economi unity of the group had ceased and also after technical affiliatio had ended. It will be seen further that the filing of the claim fc refund of 1942 taxes and the 1944 returns also occured after th Operating Company was out of the hands of the Trustees. (Se Chronology, appearing on the flyleaf of this brief.) The defenc

ant Operating Company is the party which joined in all these income tax returns, both during and after bankruptcy. During bankruptcy, although it was in the hands of the Trustees, it joined in the returns in its own name by virtue of Section 52 of the Internal Revenue Code.

THE $10,100,000 RESERVE FUND TO PAY THE TAXES.

Throughout 1943 the Operating Company made accruals to meet the expected 1943 tax liability in excess of $7,000,000, and for the first four months of 1944 it made accruals in an amount exceeding $3,000,000 (614 P 56, 1818-1824, P 76).

When Polk decided in December 1943 that the Corporation's loss could and should be used in the 1943 returns, he recommended that the accruals on the Operating Company's books for 1943 taxes be reversed, but that, because of uncertainties as to the allowance of the Corporation's loss as an offset to Operating Company income, these funds be placed in a special reserve until the taxes were finally determined (602). This was done by order of the Bankruptcy Court on March 3, 1944, when $7,100,000 was ordered designated "Reserve Fund for Contingent Tax Liabilities" and invested in U. S. Treasury securities to be used to pay any federal taxes found to be due for 1943 (616).

In March 1945, three months after it was out of the hands of the Trustees, the Operating Company established a further reserve of $3,000,000 against federal taxes, which was also invested in government securities (616).

These reserves, aggregating $10,100,000, were still intact in the hands of the Operating Company at the time of the trial. They were built up out of earnings during the very years for which the Corporation's loss was used to discharge the Operating Company's taxes.

Since the tax settlement with the government, these reserves have been carried by the defendant as a contingent reserve to meet any judgment in the present action (517, 518).

THE OPERATING COMPANY AFTER REORGANIZATION.

Although the Operating Company is the same legal entity throughout, before, during, and after bankruptcy, it is now a complete financial stranger to the Corporation and has been since March 15, 1943, albeit "paradoxically" affiliated for income tax purposes until April 30, 1944.

When it emerged from reorganization on December 29, 1944, the Operating Company had entirely new owners. The Corporation's investment of $75,000,000 had been wiped out and a creditor's claim of $7,750,000 as well. No other interest was wiped out except that of a subsidiary of plaintiff, amounting to $61,667. Other interests were given income or equity securities in place of fixed debt, or scaled down, but these securities were greatly enhanced in value by the operations during bankruptcy when $30,000,000 of revenue was devoted to additions and betterments and $6,000,000 to rolling stock (1944 Annual Report P 20C, page 9; reprinting in the record of the annual reports was dispensed with by this court (2175)).

From the effective date of the Reorganization Plan until the re vesting in December 1944, the Operating Company's net income was sufficient to meet all bond interest and sinking funds required by the Plan, and leave $20,658,938 applicable to other corporate purposes (1196). In 1943, net income was sufficient, after a deduction for taxes of $7,100,000 (never paid because of the use of the Corporation's loss) to pay all interest and preferred stock dividend requirements and still leave $8,929,844 available for common dividends (1195).

When it emerged from bankruptcy January 1, 1945, the Operating Company had an unappropriated earned surplus of $30,000,000 (1945 Annual Rep. P 20D, page 15).

SPECIFICATION OF ERRORS RELIED UPON

Appellants' statement of points on which they intend to rely on this appeal are set forth at page 2168 of the record. They are fourteen in number but may be summarized as follows:

1. The court erred in failing to hold that the plaintiff Corporation is entitled to an accounting from the Operating Company for the benefits which it obtained as a result of satisfying its tax liabilities by using tax credits and deductions belonging to the Corporation at a time when the Corporation had no financial interest or ownership in the defendant Operating Company.

2. The court erred in holding that what the plaintiff seeks is something in the nature of equity or value for its former ownership of stock in the defendant, or something denied it under the Reorganization Plan.

3. The court erred in holding that the allowance of the deduction of plaintiff's loss from defendant's income for tax purposes was improper, and that such asserted impropriety precluded recovery by plaintiff in this action.

4. It further erred in giving no effect to the stipulation that 3,385,290 of 1942 taxes must be deemed to have been refunded o the plaintiff and by it paid into court.

THE LEGAL QUESTION PRESENTED AND THE TRIAL COURT'S DECISION

The question here is whether the defendant must account to he plaintiff for the benefits which the defendant obtained by satsfying its federal tax liabilities by using tax rights belonging o the plaintiff, at a time when the plaintiff had lost its stock quity in the defendant, and where the tax rights arose out of hat very loss.

It is submitted that under the facts the defendant must account or the following reason:

The defendant has been enriched as a result of using plaintiff's ghts. That enrichment is unjust because under the tax law the rent corporation whose rights make tax savings possible (the aintiff here) is entitled to the benefits arising from the use of ose rights in consolidated returns. That enrichment is also unst because defendant occupied a fiduciary relation to plaintiff d may not retain a benefit received as such fiduciary through

the use of plaintiff's rights. There being an unjust enrichment, defendant must make restitution.

The trial court found the facts in favor of plaintiff. But it rendered judgment for defendant. Then, on timely motion, it amended the judgment to provide that defendant should not recover its costs (325) because "under all of the circumstances of this litigation, it would be more just if each side were to bear its own costs" (323).

The basis of the court's decision was its belief that it was "puzzling, if not downright amazing" that the Operating Company could avail itself of the Corporation's loss (267); that the tax "escape" of the Operating Company was "erroneous and unjust" (271); and that if the court "had the power, I would not hesitate to set aside the tax settlement * * * and order these taxes paid to the United States" (270).

The court was further of the view that the Corporation was not really seeking to share in the tax savings, but that its suit was "rather * * * a circuitous way of obtaining something in the nature of equity or value for its ownership, rejected in the reorganization plan" (272), and that "to make any award, in this cause, under the assumed authority of equity principles, would be in effect to modify the administrative and judicial judgments in the reorganization proceeding" (274).

It concluded that "as between the parties, no persuasion of conscience or equity impels me to do otherwise than to leave the parties where they are, the defendant with the amazing and undeserved tax success; the plaintiff, as the reorganization decree left it, without interest in the debtor" (276).

At pages 76-95, infra, we shall discuss the trial court's reasoning and show that it is not sound.

SUMMARY OF THE ARGUMENT

Although the court below referred to the income tax picture presented by this action as "bizarre" (265) and the defendant's use of the tax statute as "puzzling, if not downright amazing" (267), the record reveals that, while the facts are unusual, the

are not in dispute, and the legal principles involved are simple and their application clear.

If the subject matter of this suit were a white horse belonging to the plaintiff, which the defendant appropriated to its own use, it would not take a court long to hold that the defendant was accountable to the plaintiff. That the subject matter is a $75,000,000 loss sustained by the plaintiff, which the defendant used to discharge its $17,000,000 tax liability, may present a novel factual situation, but it does not involve unusual legal principles.

The amount is indeed large, but this does not affect the merits. Any shock which the defendant might suffer through having to account for its enrichment is cushioned by the fact that it possesses a funded reserve, consisting of $10,100,000 of government bonds, for the specific purpose of responding to any judgment rendered against it in this action. This reserve was built up out of charges to current earnings during the years in question for the purpose of paying the very taxes which were later discharged by the use of plaintiff's loss. It would have long since been paid to the United States and spent for war purposes, like the taxes paid by other railroads, had the defendant not used the plaintiff's loss to satisfy its taxes.

Both the controlling facts and the legal principles involved are simple.

The controlling facts, in summary, are these:

1. Plaintiff sustained a loss of $75,000,000.

2. This loss was of value to anyone who could use it for the purpose of reducing or eliminating income tax. To that extent it was a thing of value, and it was plaintiff's.

3. It could not be used except by plaintiff or with its consent evidenced by a consolidated return in which it joined.

4. Defendant appropriated that loss and right of use to its own benefit to the extent of $17,000,000.

5. It was able to do this because it occupied a fiduciary relation to plaintiff and a position of dominance and because of duality of positions occupied by officers and employees.

6. By reason of the fiduciary relation and duality of representation, plaintiff was incapable of precluding itself from recovering compensation for this appropriation, by any agreement it might make, or of protecting itself by an agreement, and in fact, because of that fiduciary relation and duality, it made no agreement on the subject.

7. Plaintiff had been a parent and defendant a subsidiary. Defendant's appropriation of plaintiff's loss occurred after plaintiff and defendant had become economic strangers to each other.

The legal principles under which plaintiff's right of recovery flows from these facts may be summarized thus:

A person who is unjustly enriched through use of what belongs to another is required to make restitution to the other. A person is enriched if he has received a benefit. Saving another from expense or loss confers a benefit just as much as the actual delivery of property. A person is unjustly enriched if the retention of the benefit would be unjust.

The purpose of the tax statute in permitting consolidated returns is to allow the group to be regarded as an entity, balancing losses against gains, and thereby necessarily to ameliorate the losses of the parent by the amount of the tax saving. It is not the purpose to permit the subsidiary to escape its just taxes.

When a parent's loss is used in consolidated returns to discharge a subsidiary's tax liability, at a time when the parent-subsidiary relationship has been severed and the parent has no further interest in the subsidiary, the subsidiary should account to the parent for the benefit arising from the use of the parent's loss. Retention would be unjust.

Moreover, one who occupies a fiduciary relation to another, as the Operating Company did to the Corporation, may not use that relationship, or the opportunities it affords, or the rights of the other, to obtain a personal benefit, and if he does, he must account for that benefit.

With respect to the reasons expressed in the opinion of the court below, this may be said, in summary:

The use of plaintiff's loss as a tax deduction was proper. Apart from that, the propriety of the tax savings as respects the Treasury was simply not an issue in this action. Moreover, as between the parties it would be no answer to the duty of defendant to account to plaintiff even were there some impropriety in the tax deductions as respects the Treasury, a fact which is nowhere shown in the record and which is unfounded in law.

Under the law consolidated returns could be filed and the Operating Company's tax liability discharged by the Corporation's loss. This was done, and the Treasury Department, after a formal hearing, agreed in writing to this result. The court's comments as to what it would do with the tax settlement if it had the power (i.e., set it aside and order the taxes paid to the government) are entirely gratuitous. They are understandable, however, on the basis that it would be unconscionable for the Operating Company to escape the payment of its just wartime taxes merely because its former parent had lost its $75,000,000 investment, without any accounting to the former parent for the benefit thus received.

The defendant Operating Company conceived, planned, directed and carried through the tax arrangement. It used the Corporation's loss to discharge $17,000,000 of its taxes. The tax savings sanctioned by the tax law and agreed to by the Treasury Department should go to the plaintiff Corporation to ameliorate its loss. Any judicial resentment flowing from the astonishment provoked by the unusual tax result should not be directed against the Corporation, whose crushing loss was the basis accepted by the government for cancelling the Operating Company's taxes. Rather, it should be directed to seeing that the benefit intended by the tax statute should accrue to party for whose relief the statute was conceived.

Similarly, the trial court's view that the plaintiff is seeking to obtain something in the nature of equity or value for its former ownership, rejected in the Reorganization Plan, is erroneous. The Reorganization Plan was drastic and wiped out the entire

equity of the stockholder although the railroad was earning a large income. But plaintiff does not seek to go behind the Plan and its drastic treatment. The consummation of the Plan stripped the plaintiff of its ownership but left plaintiff with something in its place—a large loss. The defendant then went beyond the Plan and appropriated what plaintiff had left in order to fatten its surplus by an additional $17,000,000, something never contemplated by the Plan. The tax savings which gave rise to plaintiff's claim—as a creditor of defendant and not as a former stockholder—arose after the Plan was effected and consummated.

Argument

I.

PLAINTIFF IS ENTITLED TO RECOVER UNDER THE EQUITABLE PRINCIPLES OF UNJUST ENRICHMENT

Fundamentally, plaintiff is entitled to recover on the equitable principle of unjust enrichment. The law of quasi-contract is based on that principle, and it is in the law of quasi-contract that law and equity continue to maintain that capacity to do justice in new situations for which the Anglo-American system of jurisprudence is deservedly famous.[1]

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[1] 1 Williston on Contracts (Rev. ed.), p. 9, states:

> " * * * quasi-contractual obligations are imposed by the law for the purpose of bringing about justice without reference to the intention of the parties * * *"

and

> "As the law may impose any obligations that justice requires, the only limit in the last analysis to the category of quasi contracts is that the obligation in question more closely resembles those created by contract than those created by tort."

And cf. Sloss, J., in *Humboldt Sav. Bank v. McCleverty*, 161 Cal. 285, 292: "It has always been the pride of courts of equity that they will so mould and adjust their decrees as to award substantial justice according to the requirements of the varying complications that may be presented to them for adjudication." And cf. *Addison v. Holly Hill Co.*, 322 U.S 607 at 620.

The applicable principle is set forth in the *Restatement of Restitution,* Section 1:

> "A person who has been unjustly enriched at the expense of another is required to make restitution to the other."

The meaning of this rule is amplified by the Comment that follows:

> "a. A person is enriched if he has received a benefit (see Comment b). A person is unjustly enriched if the retention of the benefit would be unjust (see Comment c). A person obtains restitution when he is restored to the position he formerly occupied either by the return of something which he formerly had or by the receipt of its equivalent in money. Ordinarily, the measure of restitution is the amount of enrichment received (see Comment d), but as stated in Comment e, if the loss suffered differs from the amount of benefit received, the measure of restitution may be more or less than the loss suffered or more or less than the enrichment."

Comment b states:

> "What constitutes a benefit. A person confers a benefit upon another if he * * * in any way adds to the other's security or advantage. *He confers a benefit not only where he adds to the property of another, but also where he saves the other from expense or loss. The word 'benefit,' therefore, denotes any form of advantage.* The advantage for which a person ordinarily must pay is pecuniary advantage. * * *"

It is self-evident that in the present case defendant has been nriched. Here the discharge of defendant's tax liability, by the se of plaintiff's loss and credits, was the conferring of a benefit pon the defendant and its enrichment, within the meaning of ıe law of quasi-contract, just as much as if the defendant had ıken dollars from the plaintiff and with those dollars discharged s tax liability.

The Shreveport Bank Cases.

The duty to make restitution applies just as much where the enrichment consists of tax savings as where it consists of some other kind of benefit. In *Commercial Nat. Bank in Shreveport* v. *Connolly,* 176 F.2d 1004 (5 Cir.) decided September 6, 1949, the very day that the court below rendered its opinion in this case, one corporation was ordered to account to another for tax savings resulting from the use of the latter's tax credits. Numerous other issues were involved in the suit, but on the issue that is relevant here the facts are as follows:

The Commercial National Bank *of* Shreveport [the old bank], being in financial straits, transferred its assets to a new bank, Commercial National Bank *in* Shreveport [the new bank], and the latter assumed its liabilities. Later a receiver for the old bank was appointed. Still later the receiver sued the new bank for an accounting.

The State of Louisiana, in which the banks were located, imposes a tax on the capital stock of national banks, assessable against the bank. In determining the assessable value of the stock, the Louisiana law provides that the assessed value of real estate owned by the bank is deductible from what would otherwise be the value of the stock.

Over a space of 5 years the new bank, in determining the tax value of its capital stock, treated the real estate of the old bank, which had been transferred to the new bank and stood in its name, as its own property. Thereby, over a period of 5 years it paid in taxes $192,000 less than it otherwise would have. In short, it saved taxes of $192,000.

In *Leslie* v. *Commercial Nat. Bank In Shreveport,* 28 F. Supp. 927, the District Court found that the property had been transferred by the old bank to the new in pledge and therefore still belonged to the old bank. On this factual basis it held that the new bank must account to the old bank for this tax savings, even though the old bank had suffered no detriment. Its reasoning was as follows (p. 933):

"* * * There can be little question but what the relation of the new Bank to the old and the administration of the property and estate intrusted to the former, was one requiring the utmost good faith and constituted it an agent, trustee or fiduciary. * * * It could not profit therefrom in any manner other than as provided by the contract, or permit anyone else to do so. * * *

"* * * The fact that the new Bank and its officers would be placed in a dual relationship with respect to the old and new Banks and their respective stockholders, was necessarily known to both sides, as parties to the contract, because of its very nature. * * * I do not believe that the property of the Old Bank could be thus used without its consent to the benefit and profit of the stockholders of the new Bank, and the latter should not be allowed to take credit for the taxes paid under the circumstances of this case.

"* * * The fact that the Old Bank suffered no loss or will be benefited by this conclusion makes no difference. (See the authorities above cited.)"

On appeal the Circuit Court of Appeals for the Fifth Circuit agreed with the District Judge on this phase of the case. *Commercial Nat. Bank in Shreveport* v. *Parsons,* 144 F.2d 231. The court said on this point:

"It was the appellant's duty as pledgee and liquidator to pay taxes on the trust estate, and the amount so paid was properly charged to the old bank; but appellant had no right to deduct from the assessed value of its own capital stock the value of such real estate as was shown on its published statements, because it was not the owner thereof within the meaning of the statute authorizing such deductions. *The credit thus obtained by the new bank was a profit derived from the trust property as effectively as if it had been paid that much in cash.* This was a profit of $191,-778.55, which over a series of years was obtained by appellant from the use and possession of, and record title to, trust property. It clearly does not belong to the trustee or to its stockholders. What shall be done with it in an accounting between the trustee and the cestui que trust?

"* * * We concur in the opinion of the court below that the items in controversy should have been credited to the

cestui que trust, and refer to the authorities therein cited." (pp. 236, 237)

A petition for rehearing was denied, 145 F.2d 191, as was certiorari, 323 U. S. 796.

On remand the new bank sought leave to deny that the assets had been transferred in pledge and to assert that they had been transferred outright. The trial court adhered to its decision relative to the tax savings. *Connolly* v. *Commercial Nat. Bank in Shreveport,* 72 F. Supp. 961 at 963.

On a second appeal, the Court of Appeals sat en banc. This time a majority of the court held that most of the assets had been transferred outright to the new bank, and that consequently the tax savings derived therefrom resulted from the new bank's own property.

But as to certain other assets, it was held that they had been transferred in pledge, and that the new bank must account to the old for tax savings resulting from their use. *Commercial Nat. Bank in Shreveport* v. *Connolly,* 176 F.2d 1004 (Sept. 6, 1949). On the first appeal there had been one dissent as to the duty to account for the tax savings. But on the second appeal the court's opinion was written by the very judge who had dissented on the first appeal. Thus the whole court finally concurred that there was a duty to account for tax savings to the party whose rights were used to achieve that saving. The court said (p. 1008):

> "* * * the New Bank should account to the receiver of the Old Bank for all such savings as accrued to it from the inclusion of any Class C real estate in its capital stock tax return."

The rationale of the dissenting opinion on the first appeal was similar to that of the court below in this case. The fact that the dissenting judge abandoned those views on the second appeal and embraced the other opinion is significant. We shall consider this phase of the case further (pp. 84, 85, below).

A. THE RETENTION OF THE BENEFITS RECEIVED BY DEFENDANT WOULD BE UNJUST FOR TWO MAJOR REASONS. THE FIRST REASON IS THAT SUCH RETENTION IS INCONSISTENT WITH THE RATIONALE AND PURPOSES OF CONSOLIDATED RETURNS.

We have seen that the defendant has been enriched. And we have seen that if the enrichment was unjust, plaintiff is entitled to recover. The enrichment was unjust for two independent reasons, each of which we shall discuss.

The first reason is that such retention is inconsistent with the rationale of consolidated returns and with the purpose of Congress in allowing them.

The principle underlying consolidated returns—their rationale—is summarized in II Montgomery's Federal Taxes, Corporations and Partnerships, 1946-1947 issue, at page 633, where legislative reports and similar material are quoted.[2] The principle is this: A group of affiliated corporations is an economic entity and, unless the group as a whole in the conduct of the business enterprise shows net profits, those who conduct the business—*the owners of the parent*—have realized no gain, despite the legal fiction of separate corporations. As said in *Handy & Harman v. Burnet,* 284 U.S. 136, 140, the purpose is

> "to require taxes to be levied according to the true net income and invested capital resulting from and employed in a single business enterprise, even though it was conducted by means of more than one corporation."

The rationale of consolidated returns "is the recognition of this common owner's right to set off against his gains in the one

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[2]Consolidated returns were first required, but only for excess profits tax, by Treasury Regulation in 1917. This was validated by the 1921 Act. Consolidated returns were compulsory for both normal and excess profits taxes between 1918 and 1921, inclusive. They were permissive but not mandatory for 1922-1933, inclusive. They were not permitted, except in case of certain railroad corporations, from 1934-1939, inclusive. They were permissive for all corporations with respect to excess profits taxes in 1940 and 1941. In 1942 the Revenue Act, Section 141 (a), extended the privilege to all corporations for all years after December 31, 1941, with respect to both normal taxes and excess profits taxes. (For the foregoing history see II Montgomery's Federal Taxes, Corporations and Partnerships, 1946-1947 issue, at p. 632.)

[corporation] his losses in the other [corporation]." *Duke Power Co. v. Commissioner of Internal Revenue,* 44 F.2d 543 at 545 (4 Cir.), cer. den, 282 U.S. 903, containing an excellent statement of the history and purpose of consolidated returns and the concept of the economic unity. So also *Alameda Inv. Co. v. McLaughlin,* 28 F.2d 81 (D.C. N.D. Cal.), aff'd 33 F.2d 120 (9 Cir).

In Appendix One to this brief we quote from some of the legislative history on the subject.

When the law recognizes the group of affiliated corporations as an economic entity and permits the offsetting of the profits of one affiliate against the losses of another, it does so for the purpose and with the effect of benefiting the ultimate owners of the business entity, who are, of course, the stockholders of the parent corporation. The means which the law adopts to benefit these ultimate owners is the amelioration of the loss suffered by the ultimate owners because of losses of any one affiliate; this amelioration is accomplished by permitting the losses to reduce or eliminate, for tax purposes, the profits of other affiliates.

The present case is an unusual one because the economic unity between the parent and the subsidiary was severed before the tax saving was claimed or achieved, the severance being the very fact that produced the loss.

In such a case, if the tax saving is permitted to be retained by the former subsidiary after severance of the economic unity, without making restitution to the parent, particularly where the loss was that of the parent directly, both of the underlying principles of the consolidated return provisions of the income tax law have been defeated:— (1) The stockholders of the parent corporation will not obtain the benefit resulting from filing a consolidated return, and (2) in addition, the loss which they suffered—and here suffered directly—will not have been ameliorated.

On the contrary, new owners of the former subsidiary will reap a profit—a sheer windfall—from the misfortune of the old owners. The income tax laws will have been used to enrich complete strangers to the economic entity for whose protection consolidated returns are permitted. The fact that the retention of the enrich-

ment would defeat the policy of the statute shows the enrichment to have been unjust.

In *Woolford Realty Co. v. Rose,* 286 U.S. 319, the Supreme Court (Cardozo, J.) held that the use of consolidated returns did not permit a corporation to deduct from its profits the loss of an affiliate sustained in a year prior to that in which the affiliation began. "The mind rebels against the notion," it said, "that Congress in permitting a consolidated return" was willing to permit a corporation to profit by the loss of one who was a stranger when the loss was sustained.

In the present case we have the converse situation, for here the tax savings were claimed after the economic unity was destroyed, and laws and regulations had come into effect subsequent to *Woolford* which permitted the tax saving in this case. But it is just as shocking to one's sense of justice to permit the defendant to appropriate for its *own* benefit losses with which it had nothing to do, as it was in the *Woolford* case to contemplate the appropriation by one affiliate of the losses suffered by another in years prior to the time of affiliation.

If the economic unity had not been severed, the benefits would still inure to plaintiff though retained by defendant. But "the mind rebels against the notion" that, after the economic unity has been terminated, the defendant may appropriate plaintiff's tax credit resulting from plaintiff's losses without making restitution. In the language of the *Woolford* case, "to such an attempt the reaction of an impartial mind is little short of instinctive." This "instinctive reaction" of which the Court speaks is the equivalent of the conscience of the chancellor, the "good conscience" with which the law of quasi-contract and unjust enrichment is concerned, and which determines whether an enrichment is just or unjust. *The party whose loss made the tax saving possible should receive it as a partial amelioration of its loss,* rather than another who was not in good conscience entitled to any tax saving whatever.

In *Helvering v. Morgan's, Inc.,* 293 U.S. 121, 127, the court said that "After affiliation, as before, the affiliated corporations,

although filing consolidated returns, continued to be separate taxable units. The consolidated returns operated only to unite them for the purpose of tax computation and the equitable apportionment between them of the tax thus computed."

Equitable apportionment of the tax involves equitable apportionment of the savings, and *what is equitable must be decided in the light of the fact which distinguishes our present case from all others, namely, that the corporations are in fact separate entities,* not merely legally, as the *Morgan's* case indicates is true of all affiliates filing consolidated returns, but also economically and factually.

The Report of the Senate Finance Committee on the Revenue Bill of 1928, 70th Congress, 1st session, Senate Report 960, which we quote in part in appendix one to this brief, also stated that "Much of the misapprehension about consolidated returns will be removed when it is realized that * * * *no ultimate advantage under the tax laws really results.*" Similarly, in the Report of the Senate Finance Committee on the Revenue Bill of 1932, 72nd Congress, 1st session, Senate Report 665, at page 9, it was said concerning consolidated returns, "No improper benefits are obtained from the privilege."

After quoting these passages, the Board of Tax Appeals in *J. D. & A. B. Spreckels Co.,* 41 B.T.A. 370, 375, answered in the negative the question "whether or not the framers of the statute intended that the privilege of making consolidated returns may be enjoyed in cases where the affiliation does not serve a business purpose, as distinguished from a tax-reducing purpose."

No purpose other than a tax reducing purpose could have been served in the present case *except by applying the tax savings to ameliorate plaintiff's loss.* Otherwise, it cannot conceivably be said that "no ultimate advantage under the tax laws really results" or that "No improper benefits are obtained from the privilege."

The Law and Regulations Concerning Joinder in Consolidated Returns by One in Receivership or Bankruptcy.

Section 52 of the Internal Revenue Code provides that when a trustee in bankruptcy is operating the business of a corporation, he shall make the income tax returns for it in the same manner and form as corporations are required to do, and the tax due on the basis of the returns shall be collected in the same manner as if collected from the corporation.

Treasury Regulation 104, Sec. 23.15, subd. (b), provides that if one or more, but not all, of the members of an affiliated group are in bankruptcy, the tax liability of each such member for the period covered by a consolidated return shall not exceed such portion of the consolidated tax liability as the affiliates may agree upon, or, in the absence of such an agreement, an amount equal to its liability "computed as if a separate return had been filed."

And in the fall of 1942, Section 23(g)(4) was added to the Internal Revenue Code to permit the loss of a parent corporation resulting from worthlessness of stock of a subsidiary to be used as an operating loss. But for this amendment the plaintiff's loss could not have been used to offset defendant's income.

Bankruptcy of a subsidiary usually makes the stock interest of the parent valueless and deprives the parent of control over it. However, under the foregoing provisions, any stock loss of the parent resulting from the bankruptcy is offsettable against the income of the subsidiary, the subsidiary being permitted to pay a tax computed "as if a separate return had been filed," thus giving the tax benefit of the parent's loss to the parent.

The several provisions of the law and regulations thus show a legislative intention that a parent whose subsidiary goes into bankruptcy, with resulting loss of the value of the parent's stock, should have the benefit of any tax saving resulting through the filing of consolidated returns and the offsetting of the subsidiary's income by the parent's loss.

Defendant's tax counsel, Polk, explained the purpose of the 1942 change in the tax law, made by the addition of Section 23 (g)(4), as follows (1447):

"Q. As a matter of fact, this case could not have happened except for a change in the law in October 1942, could it?

"A. No, it could not have.

"Q. What was that change in the law which made this possible?

"A. Well, there was a *very unfair situation* in consolidated return accounting up to that point that section 23(g) (4) was designed to correct. You see, under consolidated returns inter-company transactions are eliminated, and where a parent corporation puts out its cash for a subsidiary company and then the subsidiary company becomes worthless, if you eliminate the worthlessness as an intercompany transaction, *there has been,* in the usual case, *a deprivation of capital, a loss of capital and no reflection for tax purposes, and that was corrected* by the insertion into the Internal Revenue Code of Section 23(g) (4)."

The "unfair situation" of which Polk spoke was that the *parent* had lost capital but derived no tax benefit from it. This "unfair situation" was corrected by the 1942 amendment. To permit the subsidiary to profit, instead of having the tax saving applied to ameliorate the parent's loss, would utterly fail to correct any such unfairness.

S.E.C. Decisions.

In point is a ruling of the Securities and Exchange Commission, entitled *"In the Matter of Consolidated Electric and Gas Company"*, 15 S.E.C. Decisions and Reports, 161 (1943). That case arose under the Public Utility Holding Company Act of 1935.[3] Section 12 prohibits certain intercorporate transactions between parents and subsidiaries, and the Act requires notice of intended transactions to be filed with the Commission to give it an opportunity to pass upon them. S.E.C. Regulation U-45 prohibits cer-

[3]Since that Act regulates gas and electric holding companies and does not apply to a railroad corporation, the Act itself is not pertinent, but the problem arising under it and presented to the S. E. C. involved principles applicable here.

tain donations between parents and subsidiaries with exceptions in the case of consolidated tax returns.

In the particular case Consolidated Electric and Gas Company filed a notice with the Commission that it and its various subsidiaries had entered into a contract whereby it was to be primarily responsible for the payment of the taxes resulting from consolidated returns and each of the subsidiaries should pay as its share an amount representing that percentage of the total consolidated taxes of the group which the tax of the particular company, computed on a separate basis, would bear to the total amount of taxes of all the parties, computed on a separate basis.

A consolidated return was to be filed for 1943, and a tax saving of $2,156,804 would result from the fact that the parent had or would suffer a loss in disposing of its investment in approximately nine subsidiaries. This loss was, for tax purposes, in every respect identical with the loss sustained by the plaintiff here from the worthlessness of its stock in the defendant.

Consolidated Electric desired approval of its determination to alter the agreement so as to permit the remaining subsidiaries to make direct payment to it of amounts equal to those that they would save under the consolidated return by virtue of the capital loss incurred by the parent company.

The Commission approved this proposal, thereby holding that it was equitable that the affiliate securing the benefit of the tax saving resulting from the parent's loss should pay the amount of such saving to the parent which had suffered the loss. The Commission said that

> "To the extent that tax savings may accrue to the parent in connection with such sales, the result is in effect to reduce the amount of loss accruing to Consolidated by virtue of the transaction" (p. 163)

and expessed its conclusion as follows:

> "Under all the circumstances, we believe that it is more realistic to view the tax savings as, in effect, partial offsets to the capital losses otherwise suffered by Consolidated in connection with the sales." (p. 164)

In the *Consolidated* case the affiliation continued. Consequently, as the Commission remarked, the savings eventually would have inured to the parent anyway by virtue of dividend payments, or, if the parent should dispose of its stockholdings in the subsidiaries, by increasing the value of the stock. The injustice of not having the tax savings transferred immediately to the parent would therefore not have been great. Nevertheless the Commission felt that a direct transfer was appropriate. *A fortiori,* in the present case, where the economic unity has been split so that the tax savings cannot inure to the parent by virtue of dividends, the justice of requiring the defendant to transfer the tax saving to the plaintiff to ameliorate its loss, by virtue of which alone the savings was possible, is apparent.

In another matter before the S. E. C. involving the same parent, *In the Matter of Consolidated Electric and Gas Company,* 13 S.E.C. Decisions and Reports 649 the loss was that of Islands, one of the subsidiaries, instead of the parent as in the case just reviewed. By means of consolidated returns the parent and affiliates other than Islands saved nearly $1,500,000 in taxes by reason of Island's loss.

The S. E. C. approved an application of the parent to pay to Islands an amount equal to the tax savings of the parent and other affiliates, since (13 S.E.C. at 658)

> "The tax savings * * * has its origin in a loss sustained by Islands and it seems eminently equitable that the cash be applied, as proposed, to the satisfaction of the Series A bonds of Islands, the holders of which have legal recourse against Islands alone."

Two principles of equity are apparent from these cases: (1) that the tax saving should go to the ultimate owner of the economic entity—the parent, and (2) that it should go to the party suffering the loss, to ameliorate it. So long as the economic unity continues, these two principles coincide, for no matter which affiliate sustains the loss in the first instance, the parent also sustains it—at once if it is the affiliate, or ultimately if the loss was

that of a subsidiary. Thus, in the *Islands* case the parent allocated the tax benefits, resulting from a loss, in a manner best serving its own interests, for by using the tax savings to pay off the subsidiary's bonded debt the parent increased the value of its own equity.

In the present case, too, both equities coincide, the equity that the tax saving should go to the parent and the equity that it should go to the party sustaining the loss, to amelioriate it. Both equities sustain plaintiff's right to recover. And both demonstrate that it would be inequitable for the tax savings to go to one that was neither the parent nor the sufferer of the loss.

The Trial Court Recognized the Injustice of Defendant's Keeping the Tax Savings and Yet for That Very Reason Denied Plaintiff Recovery.

For defendant to keep the tax saving is, then, a subversion of the tax laws.

The trial court certainly was of that view. It so stated in its opinion in vigorous language. The consequence is that plaintiff should have judgment. To permit plaintiff to receive the benefit of the tax savings is to fulfill the object of the tax laws in permitting consolidated returns, since the only justification for the defendant's not paying its taxes was that the resulting savings would go to ameliorate plaintiff's loss.

Yet—curiously—because the trial court believed the *defendant* had wronged the government, it denied recovery to the plaintiff, thereby rewarding the defendant by permitting it to keep the unconscionable gain.

At pages 76-88, infra, we shall discuss at some length this reasoning of the trial court.

Plaintiff's Right to Recover Is Supported by Elementary Equitable Rules of Contribution.

A basic principle of equity and quasi-contract is that of "contribution". Situations often arise where, as respects a third party to whom a duty is owed, two persons are both liable; yet, as between themselves, the burden should be discharged in whole or

in part by one of them only, either because of agreement between them or apart from agreement. If one of the parties discharges the obligation, he is entitled to restitution from the other who should have done so. *Restatement of Restitution,* Section 81, Comment under Section 81, and the sections following, as well as the "Introductory Note" under Topic 3 at pages 327, et seq.

As stated on page 328 of the Restatement, even if the parties do not have in mind the necessity of such restitution, or do not think of it in detail, a duty will be imposed.

These principles apply to tax situations, including those involved in consolidated returns, as much as they do to any other situation.

Bankers Trust Co. v. *Florida East Coast Car Ferry Co.,* 92 F.2d 450 (5 Cir.) illustrates that application. That case involved a consolidated return in which the net income of one of the affiliates, "A", was greatly overstated, resulting in an excess tax chargeable to it of $195,000, and the income of another affiliate, "B", was greatly understated. The tax deficiency resulting from the understatement amounted to $99,000. Offsetting the two, there still was a net refund of $96,000 resulting from the overstatement.

Two questions arose. The first question was to whom the refund of $96,000 should go. This question presented no problem. The refund went to A, not because A had paid the money but because the refund was due to A's own tax credits; that is, on a separate return basis the $96,000 would never have had to be paid by A.

The second question was whether A was entitled to recover $99,000 from B. A had overpaid that amount in addition to the $96,000 and would have been entitled to its refund from the tax authorities except for the fact that it was applied to pay the additional tax due from B. In short, A's credit paid B's tax, as a result of the consolidated reporting.

It was held that the affiliate whose income had been overstated was entitled to reimbursement in the amount of $99,000 from the receiver of the affiliate whose income had been understated.

So, in the present case, defendant's tax liability was discharged, not by its paying anything, but by use of a tax credit belonging to the plaintiff Corporation.

The two affiliates involved in the *Florida East Coast* case were subsidiaries of a common parent. The one that had received the benefit of the other's tax credits was in the hands of receivers. Were it not for the intervention of the receivership, it would have been a matter of no practical concern whether or not the affiliate receiving the benefit of the other's credits accounted to that other, because in either event the common parent would be the ultimate economic beneficiary. It would be irrelevant whether the gain reached the parent through its ownership of the one corporation or of the other, and the ultimate disposition of the benefit would lie in the parent's hands. But the insolvency of the first affiliate, resulting in the receivership, meant that the rights of that affiliate's creditors intervened between it and its parent; there was a severance of the economic unity. If the tax benefits were allowed to remain in the hands of the receivers, they would never reach the parent. It thus became important that the incidence of gains and benefits should be placed where they properly belonged. And they were so placed in the *Florida East Coast* case by the judgment rendered.

In the ordinary situation, where there has been no severance of economic unity, questions such as these are not likely to occur. So in our case it was a matter of no moment before 1943 whether the benefit of particular tax savings should flow initially to the plaintiff Corporation or the defendant Operating Company. But once economic severance occurred, the issue became important. Here the severance occurred as the result of adjudication in 1943 that plaintiff was not entitled to an equity in the reorganized defendant. While in the *Florida East Coast* case the severance occurred because of the intervention of the rights of creditors, the principle is the same.

As respects the government, two or more parties may be liable for taxes, but this does not determine the rights of the parties

between themselves, which are governed by principles of general jurisprudence. If the tax liability is justly that of one party, either in whole or in part, and another discharges that tax liability, the latter is entitled to recover from the former, regardless of what the tax law provides about liability to the government. *Phillips-Jones Corp.* v. *Parmley,* 302 U. S. 233; *Wolters* v. *Henningsan,* 114 Cal. 433. As said by the United States Tax Court in *Koppers Co.,* 8 T. C. 886 at 891,

> "The right of contribution is not founded upon contract and arises as a matter of general law whenever one pays on a common obligation in excess of the share proper as between himself and others similarly liable."

In tax cases a right to contribution from other members of an affiliated group may arise from overpayment of one's share. *Koppers Co.,* 11 T. C. 894. Although all members of an affiliated group may be severally liable to the government for the whole tax, "as between themselves, each affiliate [is] mutually obligated under principles of general law to pay only its fair share of the common burden." *Koppers Co.,* 8 T. C. at 891.

In the present case, the plaintiff had no income and its fair share of the tax burden was therefore nothing whatever. Since defendant's tax liability was fully discharged by the use of plaintiff's tax credits, plaintiff has a right to restitution from defendant for the benefit received.

The cases just discussed show that liability for payment of taxes to the Government and the right to receive refunds from the Government are not determinative of the ultimate liability of affiliates among themselves to share the tax burden and distribute tax refunds; hence, where there is no agreement on these matters but one acts for all, a duty of contribution or distribution (as the case may be) arises which it is the province of equity to adjust simply because there is no agreement.

. RETENTION OF THE BENEFITS RECEIVED BY DEFENDANT WOULD BE UNJUST BECAUSE PLAINTIFF WAS UNDER NO DUTY TO CONFER ON DEFENDANT THE BENEFIT OF ITS LOSS, AND DEFENDANT, OCCUPYING A FIDUCIARY RELATION TO THE PLAINTIFF, APPROPRIATED THAT LOSS TO ITS OWN USE.

laintiff Was Under No Duty to Join in Consolidated Returns r to Confer on Defendant the Benefit of Its Tax Credits.

Under the tax law and regulations plaintiff was free, in each f the years in question, to file a separate return (although its ıx counsel, who were counsel for defendant, failed to so advise (see pp. 15, 16, 24, supra)).

A parent owes no duty to any subsidiary to join or not to join a consolidated return. It is free to decide solely on the basis its own interests whether consolidated returns should be filed. his principle and its rationale are declared in *Duke Power Co. Commissioner of Internal Revenue,* 44 F.2d 543, 545 (4 Cir.), here it was held that a subsidiary had no right to the benefits of consolidated return where the parent chose to file a separate turn.

Since this is true when the economic unity exists, patently the rent owes no duty to a former subsidiary to join in consolidated turns for the latter's benefit, after the economic unity has been vered, merely because continuance of technical affiliation makes sch returns permissible. In this case the economic unity was svered before the tax returns were filed. In the words of the urt *during the trial* (1380), the parties were "free agents to ree with one another to file this type of return"; that is, to agree to refuse to agree. Yet, oddly, when it decided the case, the urt observed in its opinion that "there is some merit to defend-t's contention that a firm obligation rested upon plaintiff to nform and cooperate" to give defendant the benefit of its loss 75). The opinion, however, contains no suggestion of any sons to support this view, which we submit has no substance.[1]

Elsewhere in its opinion the court asserts that the tax savings were nazing and undeserved." (276) It is impossible to reconcile the two ements. How could plaintiff be under an obligation to give defendant "amazing and undeserved" benefit?

Certain it is that the Bankruptcy Court could not have ordere the plaintiff to join in consolidated returns and to give defendar the benefit of its loss. Not only was defendant already out o bankruptcy when the 1944 return and the claim for refund wer filed, but, quite apart from that fact, the Bankruptcy Court woul have been without jurisdiction to make any such order. *Callawa* v. *Benton,* 336 U. S. 132, and *Benton* v. *Callaway,* 165 F.2d 87 which it affirmed, are conclusive on that point.[5]

Thus the suggestion that, somehow, the plaintiff might ha been under an obligation to join in consolidated returns with d fendant for the latter's benefit can only mean, if it means an thing, that the defendant by an independent suit in equity again plaintiff could have compelled it to join in such a return grat tously.

The basis of any such suit defies understanding. If the plaint had earned $75,000,000 in other enterprises in 1942, 1943 ar 1944, its $75,000,000 stock loss would have eliminated its t on that income, and no one would even think of suggesting th it could have been compelled, instead, to give the benefit of loss to defendant. Indeed, defendant conceded in its trial bri (at p. 40) that "if during the critical years plaintiff had * * taxable income * * * plaintiff would have a different case." T argument apparently is that unless plaintiff could have used loss to its own advantage, it could have been compelled to gi

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[5]Under Section 77 (the railroad reorganization section) a bankrup court's *in personam* jurisdiction is confined to the debtor. Here that defendant, for it was the defendant and not the plaintiff that was in organization. The court's *in rem* jurisdiction is confined to property in debtor's possession. It has no jurisdiction over disputes with others involving property in the debtor's possession. *Bankruptcy Act,* Sec. 77(Title 11 U.S.C., Sec. 205(a); 5 *Collier on Bankruptcy* (14th ed.) 4 *Thompson v. Terminal Shares,* 104 F.2d 1 (8 Cir.), cer. den. 308 U 559, approved in *Callaway v. Benton,* supra.

In *Callaway v. Benton,* it was held that a bankruptcy court had no j isdiction to compel another to transfer rights to the trustees or to er into a contract with them. Any attempt of the Bankruptcy Court to com the plaintiff here to join in a consolidated return would have been me an effort to exercise jurisdiction *in personam* over the plaintiff.

it away. We shall show at pp. 66-74, infra, that there is no validity to any such contention.

There was no duty, legal or moral, on plaintiff gratuitously to confer the benefit of its loss on defendant.

Had defendant openly approached and fully disclosed the situation to the plaintiff, the latter could have obtained independent officers and counsel, and the parties could then have arrived at whatever agreement on the subject seemed equitable to them, determining how the benefit of the tax saving should be apportioned. Such an agreement would have been an easy and simple way to settle the question.

But this was not done. No such agreement was made, *simply and bluntly because the defendant took over and managed the entire tax matter in a setting of duality of officers and agents.*

The court below in its opinion says (274): "In the final analysis, plaintiff's hope to succeed here depends upon whether it could have lawfully acquired these unpaid tax moneys by voluntary agreement between the directorates of the two companies. In my opinion, it could not." The reason then assigned for this conclusion is that such agreement would "nullify the Reorganization Plan". At pages 88-95, infra, we show there is no merit in that reasoning.

As we shall point out at page 75, infra, plaintiff's rights do not depend on whether an agreement could have been made prior to the realization of the tax savings. Nevertheless, an agreement between parties to a consolidated return concerning allocation of taxes or advantages is perfectly proper and not unusual. The propriety of such an agreement has always been recognized by the income tax law and regulations. Former revenue acts provided that the taxes under a consolidated return were to be assessed to the respective corporations in such proportions as they might agree upon and prescribed no other basis unless the the parties failed to agree.[6] Under the present law the matter is

[6]Act of 1921, Sec. 240(b), 42 Stat. 260; Act of 1924, Sec. 240(b), 43 Stat. 288; Act of 1926, Sec. 240(b), 44 Stat. 825.

left to Treasury regulations (Internal Revenue Code, Sec. 141 Subd. b). These recognize such agreements so long as they do no lessen the liability of any affiliate to the Treasury, the whole ta being assessable against any one of the corporations joining in the return (Reg. 104, Sec. 23.15(a)). Indeed, Sec. 23.15(d) rec ognizes an agreement even though it limits liability of any on corporation to the Treasury, if that affiliate is in bankruptcy.

The propriety of voluntary agreements between parties is fur ther shown by the two cases before the Securities and Exchang Commission involving the *Consolidated Electric* system, whic we discuss at pages 44-47, supra. It is further shown by *Truncal* v. *Universal Pictures Co.,* 76 F. Supp. 465, which we discuss a pages 71, 72, infra.

And it is also shown by an order entered on July 29, 1947, in the United States District Court for the Eastern District o Missouri in railroad reorganization proceedings entitled *"In th Matter of Missouri Pacific Railroad Company, Debtor,"* No. 693 (unreported). There a parent railroad owned all the stock an bonds of a group of affiliated railroads, known as the "Gul Coast Lines." It also owned all the stock of another compan the International. All of these companies were debtors in th same bankruptcy proceedings and were operated by the on trustee. Separate tax returns for 1946 would result in no tax fo the International but in a liability of over $2,500,000 for the Gul Lines, but under a consolidated return International's loss woul reduce the tax liability of the others by over $2,000,000.

Since all the parties were operated by the same trustee, a agreement by him in his capacity of trustee for one of the grou with himself as trustee for the others required approval of hi court (because of duality). For that reason he applied to th court to approve an arrangement whereby a consolidated retur would be filed and the Gulf Lines would pay to Internationa about $1,860,000 of their resulting tax savings in consideratio of International's joining with them in the return. The court ap proved the arrangement.

The basis of the allocation in that case is not relevant, because : was reached by mutual agreement, but the case is relevant as howing the propriety of an agreement on the subject.

efendant, in a Position of Dominance, Appropriated Plaintiff's oss and Is Subject to the Obligations of a Fiduciary.

Professor Scott says of quasi-contractual liability:

> "In general one is entitled to recover for benefit conferred unless he intended to make a gift or acted officiously." (2 *Scott on Trusts*, Sec. 269.3, p. 1520)

Iow much more so is this true where one does not voluntarily onfer the benefit but where it is taken by the defendant!

The situation may be likened to that involved in *Whiting v. Iudson Trust Co.*, 138 N.E. 33 (N.Y.). There an executor and ustee, having embezzled money from the estate, replaced it with unds diverted from another estate of which he was also executor. he first trust estate—guilty of no fraud—was held liable to the econd on principles of quasi-contract. Judge Cardozo said (p. 8):

> "The defendant's enrichment is a direct and immediate, not an indirect or collateral, consequence of the act of the trustee. It is an enrichment independent of the volition of the defrauded plaintiff or of those for whom he acts. The fruits of the tort are profits in the coffers of the estate. We cannot characterize enrichment so procured as other than unjust. * * * The trust is still augmented by assets unconscionably retained."

Plaintiff here made no gift of its loss to defendant. The latter mply took it. Even if plaintiff's directors had realized what was ing done and even if they had had a donative intent, no gift uld occur. The duality of position of plaintiff's representatives ould preclude any claim of an effective corporate intent to make gift. In addition, plaintiff's directors had no power to grant a atuity, for stockholders' rights cannot be given away. *Brayton v. Welch*, 39 F. Supp. 537; *Greene County Nat. Farm Loan Assn.*

v. Federal Land Bank, etc., 57 F. Supp. 783. Here the real parties in interest are plaintiff's stockholders.

Plaintiff's rights are even greater, for here defendant in its conduct of the tax matters was a fiduciary toward plaintiff.

Where one corporation has been given or takes control over the property or affairs of another, and exercises it in a manner to obtain benefits for itself, it becomes accountable for those bene fits, because control by the one over the property or affairs of the other creates a fiduciary duty not to use the control for the fidu ciary's profit. In the *Shreveport Bank* cases that rule was applied where the benefits were tax savings. (See p. 36, supra.)

Note the mechanics whereby the defendant appropriated for it own benefit the tax credits resulting from plaintiff's loss. Th operative documents which brought about this result were th consolidated tax returns for 1943 and for the first four months o 1944, the claim for réfund of the 1942 taxes and the power c attorney from plaintiff to Polk. Defendant, through its tax cour sel, prepared these documents. With them in hand, it was enable to eliminate its tax liability to the extent of $17,000,000 and di so. It filed the documents and settled the tax controversy with th government, all in plaintiff's name. All of these documents wer signed by Curry as plaintiff's president. At the time he signe them he was vice president, assistant secretary and assistant trea urer of the defendant, with his headquarters in the office of th defendant (until May 1, 1945, when his headquarters were move to the office of defendant's counsel), receiving his sole compens tion from the defendant and following, in the signature of the documents, the directions of Polk, who was defendant's tax cou sel and who, although he later solicited and secured a power attorney from plaintiff, testified that he considered he owed h responsibility to the defendant and not to the plaintiff.

The decision to use the plaintiff's loss by way of offset to d fendant's income was made by defendant through its presider Elsey; and that decision was carried into effect by defendant's a torney, Polk, whose directions to execute the documents we

ıbeyed by Curry. Curry was completely subject to the control of he defendant and its attorney, Polk, and Curry and Polk conidered themselves to be, and they in fact were, the hired hands ıf defendant. What they did with respect to the tax returns was n law the act of defendant. Insofar as tax matters were concerned, he defendant was in complete control of the plaintiff.

No clearer case of control by one corporation over the affairs ıf another, and no clearer basis for the imposition of the duties ıf a fiduciary, can be imagined.

Defendant was a fiduciary because at its own instance it volunarily took over the conduct of plaintiff's tax affairs and assumed o deal with the plaintiff's property and rights in a manner deigned to benefit itself.

It was a fiduciary because plaintiff's officers, whom defendant ısed to appropriate the plaintiff's loss, were defendant's emıloyees and the employees of its tax counsel, and paid by it and hem.

It was a fiduciary because it assumed to act as plaintiff's agent. Vhile so acting, and by use of its principal's rights, and by taking dvantage of its relationship to plaintiff, it received the $17,000,-ı00 benefit.

One becomes another's fiduciary where he assumes to and does ıke over and manage another's affairs. The law of quasi-contract derived from the Roman law, and one of the principal classes f quasi-contract was where one took over "the management of ıe affairs of another" or took over the "the management of comıon property." *Bouvier's Law Dictionary* (Rawle's Revision), itle "Quasi-Contractus". *Sandars Edition of Justinian's Institutes* 7th Ed.) p. 385, Liber III, Tit. XXVII states:—

> "if I take upon me the management of my neighbor's affairs * * * have things in common with others who are not my partners * * * the mere fact of my so conducting myself imposes on me certain duties which the law will force me to fulfill."

As said in *Commissioner of Internal Revenue v. Owens,* 78 F. l 768, 773 (10 Cir.):

"The term fiduciary is derived from the civil law. * * It connotes the idea of trust or confidence. * * * The rela tion arises whenever the property of one person is place in charge of another. McKinley v. Lynch, 58 W. Va. 44 51 S.E. 4, 9."

In the case cited (*McKinley v. Lynch*) the court quotes fron several text writers thus:

" 'It is difficult to define the term "fiduciary relation"; bu it will probably be safe, without excluding other possibl cases, to say that such a relation arises wherever a trust, cor tinuous or temporary, is specially reposed in the skill or in tegrity of another, or the property or pecuniary interest, ir the whole or in part, or the bodily custody, of one person, i placed in the charge of another'."

And again:

" 'The principles which cover the cases of dealings o persons standing in a fiduciary relation apply * * * gener ally, to the case of persons who clothe themselves with th character which brings them within the range of principal'."

In *Brooks v. Martin*, 2 Wall. (U.S.) 70, 84, the court notes th fiduciary character of one who manages a business for anothe "without consulting him in any way, and with little regard for hi * * * interest * * *."

As said by Judge Cardozo in the famous case of *Meinhard* v. *Salmon*, 164 N. E. 545 (N. Y.), at 548:

"Salmon had put himself in a position in which thought of self was to be renounced, however hard the abnegation. He was much more than a co-adventurer. He was a managing co-adventurer. * * * For him and for those like him the rule of undivided loyalty is relentless and supreme."

As this passage shows, it is enough to create the fiduciary relation that one voluntarily places himself in control of another's affairs.[7] *Southern Pacific Co. v. Bogert*, 250 U.S. 483, 492.

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[7]*Bogert on Trusts* (part 1) p. 80, quotes from *Kochorimbus v. Maggos*, 154 N.E. 235, 238 (Ill.), where it was said, "A party may voluntarily assume a confidential relation towards another * * *".

In *Overfield* v. *Pennroad Corporation,* 42 F. Supp. 586, 48 F. Supp. 1008, a judgment of $22,104,515 was entered in a stockholder's suit in favor of the Pennroad Corporation against the Pennsylvania Railroad and its directors, the court saying (at 42 F. Supp. 610):

> "The liability of the defendants in this case is based upon their dealings with Pennroad's property and powers in a manner designed to benefit Pennsylvania Railroad."[8]

A mortgagee is not ordinarily a fiduciary to the mortgagor, but he is if he has control of the property. *DeMartin* v. *Phelan,* 115 Cal. 538, 543. Ordinarily a pledgee is not a fiduciary to the pledgor, but when he takes such control or dominance he becomes a fiduciary. Such was the holding in the *Shreveport Bank* cases, supra.

The term "fiduciary" is not confined to fixed classified relationships, like trusts or agency. It exists wherever confidence is reposed, particularly where there is a disparity of position. 3 *Bogert on Trusts* (part 1), pp. 82, 83. As further said in *Bogert,* (p. 78), "Equity refuses to bind itself by an all-inclusive definition. It reserves entire freedom to declare relations to be fiduciary upon the particular facts of each case." Or, in the words of Judge Cardozo, "Equity refuses to confine within the bounds of classified transactions its precept of a loyalty that is undivided and unselfish". *Meinhard* v. *Salmon,* 164 N. E. 545, at 548.

In 1949 Professor Scott, the author of Scott on Trusts, delivered the Morrison Lecture at the California State Bar Convention, on the "fiduciary principle". He there called attention to a recent English decision, *Reading v. The King,* [1948] 2 K. B. 268, affirmed by the Court of Appeal in May 1949, in [1949] 2 K. B. 232. Reading, a British army sergeant stationed in Cairo, would ride in full uniform on trucks presumably carrying contraband.

[8]The Circuit Court of Appeals later held the claim barred by the statute of limitations but did not question the principles declared by the district court. The same issues were involved in an earlier stockholders' suit which was then revived and settled for $15,000,000. *Perrine v. Pennroad Corp.,* ' Atl. 2d 479 (Del.).

His presence in uniform deterred the Egyptian police from investigating, and he was rewarded by large sums which he banked. The British military authorities learned of his bank accounts and seized them. Reading sued the Crown for a return of the money. The burden, said the court, was upon the Crown to establish its right to the funds, so that the case was the same as if the Crown had sued Reading.

The court held that the Crown was entitled to the funds, because the facilities provided by it in the shape of the uniform, and the use of the soldier's position in the army, were the reason why the payments were made to him.

It was further held that no fiduciary relationship was necessary to establish the Crown's rights, but, if one were necessary, it was present, for "the term 'fiduciary relation' in this connexion is used in a very loose, or at all events a very comprehensive, sense," and "in the wide sense in which the term is used in the relevant cases such a relation subsisted in this case as to the user of the uniform and the opportunities and facilities attached to it" ([1949] 2 K. B. at 236 and 238.)

It hardly need be added that the relation between parent and subsidiary corporation is fiduciary, if one dominates and controls the other. What gives rise to the fiduciary relation is the element of dominance and the exercise of control and management. *Southern Pacific Co. v. Bogert,* 250 U.S. 483, 492; *North American Co. v. S.E.C.,* 327 U.S. 686, 693.

Ordinarily, therefore, the parent is the fiduciary. Here, by reason of the moribund condition of plaintiff, its loss of control over defendant, the defendant's reinvigorated condition, the switch of allegiance of the James Interests to defendant, the fact that plaintiff's officers and most of its directors were mere employees of defendant and received their livelihood from it, the subsidiary dominated the quondam parent, and the defendant was the fiduciary. As said in *Commercial Nat. Bank in Shreveport* v. *Parsons,* 144 F.2d 231 at 236, "The dominant officers of the new bank were the directors of the old, and they were doubly bound to treat the latter fairly."

More than once a parent corporation has invoked and received the protection of fiduciary standards against unfair treatment at the hands of a subsidiary; e.g., *Potter* v. *Sanitary Co. of America,* 194 Atl. 87 (Del. Ch.); *Bancokentucky Co.'s Receiver v. National Bank etc.,* 137 S.W.2d 357 (Ky.).

As a Fiduciary, Defendant Must Account for Benefits Gained.

Once a fiduciary relationship is recognized, the rights and duties are similar to those existing in the case of a trust. As 4 *Pomeroy on Equity Jurisprudence* (5th ed.) 263 says:

> "Wherever there is a fiduciary relation * * * the dealings of the parties with each other and with the subject-matter of the relation are governed by the same rules which determine the duties of actual trustees towards their cestuis que trustent * * *."[9]

And as said in *Barney v. Saunders,* 16 How. (U.S.) 534, 542:

> "It is a well-settled principle of equity, that wherever a trustee, or one standing in a fiduciary character, deals with the trust estate for his own personal profit, he shall account to the *cestui que trust* for all the gain which he has made."

Dean Roscoe Pound, in Pound and Plucknett's "Readings On The History And System Of The Common Law" (3rd Ed. 1927), at page 629, quoting Maitland's Equity, p. 83, refers to:

> " * * * one grand rule. It is this: that wherever a person clothed with a fiduciary character gains some personal advantage by availing himself of his situation as a trustee, he becomes a trustee of the advantage so gained. * * *
>
> "The rule includes persons who are not trustees properly so called, but all those who stand in what is called a fiduciary position. * * *"

This primary principle has been stated by the authorities in much the same language as respects every variety of fiduciary situation. Its gist and substance is this: The fiduciary may not avail

[9]Thus the rule of Cal. Civ. Code, Sec. 2235, concerning trustees is said to apply to all fiduciary relationships. *Metropolis etc., Sav. Bank v. Monnier,* 169 Cal. 592, 598.

himself of any advantage or facility that the position gives him. If he derives *any* benefit either from the use of any property or rights of the beneficiary or from the fact of the relationship or from the opportunities or facilities it affords, he must account to the beneficiary for the full benefit. All profits and advantages belong to the beneficiary, regardless of whether they spring from performance or from violation of the fiduciary's duty. The basic reason is that the fiduciary owes the duty of highest loyalty to his beneficiary, his personal interests must be utterly subjugated, "he must act with an eye single to the interest" of the beneficiary. And it matters not that the beneficiary has suffered no injury, that the profit was not made at his expense, or that he could not himself have made the gain. It matters not that the fiduciary acts in good faith or bad faith. Any other rule would tempt him to consider his own interest and put him in a position of conflict of selfishness with loyalty. Agreements altering these consequences may be possible, but they must follow "full disclosure of all relevant facts" and "an opportunity to obtain independent advice."

See *Restatement of Agency,* Sec. 387, 388; *Restatement of Trusts,* Sec. 203; 2 *Am. Jur., Agency,* Sec. 268, p. 215; 3 *C.J.S., Agency,* Sec. 165, p. 53; 3 *Scott on Trusts,* Sec. 502, p. 2422; 3 *Bogert on Trusts* (Part 1), p. 79.

In *Fleishhacker v. Blum,* 109 F.2d 543 (9 Cir.) this Court said, "These high standards this court is not disposed to whittle down" (p. 547), in a case where a bank officer received a side consideration for procuring a loan of the bank's funds. He was held to account to the bank for the entire consideration, and this was said to be the rule "even though the bank has suffered no damage * * * and even though the officer may have acted in good faith." (p. 546).

These fiduciary rules are applied, as has been recently stated, "with particular stringency" to dealings between interlocking corporations. *Mayflower Hotel Stock. P. C. v. Mayflower Hotel Corp.,* 173 F.2d 416 (App. D.C., 1949).

The fiduciary principle has been applied to innumerable varieties of facts, many of which "do not fall readily into any general classification." (3 *Bogert on Trusts,* (Part 1) p. 153). As Bogert further says:

> "The ways in which a fiduciary can take a position hostile to the trust and seek a private advantage are without number. In whatever form the disloyalty appears, equity penalizes it with the privilege in the cestui of obtaining a constructive trust of the advantage obtained by the wrongdoing trustee." (p. 156)

Thus the principle has been applied to compel an accounting of tax savings (*Shreveport Bank cases,* p. 36, supra) and of bribes (*Reading v. The King,* pp. 59, 60, supra).

In *Young v. Higbee Company,* 324 U.S. 204, a reorganization plan was proposed and confirmed by the District Court over the objection of two preferred stockholders that the plan was unfair. The two appealed. During the appeal they sold their stock and right of appeal for more than the market value of the stock. Other preferred stockholders thereupon sued them to obtain this profit. The Supreme Court held for the plaintiffs. The two stockholders, it said, had voluntarily become fiduciaries even though they had filed their objection on their own behalf and not on behalf of the preferred stockholders as a class, because success on the appeal would have redounded to the advantage of all. By appealing the two had assumed a "determining position over the rights of others" (p. 209) and "owed an obligation to them." (p. 210)

The plan of reorganization having been confirmed, the other preferred stockholders had lost nothing to which they were entitled. Yet it was held that the retention of the profit from the sale of their shares by the two stockholders was unjust; it "was not paid for anything they owned." (p. 212). So, in the present case, the tax saving now held by defendant was not the result of any tax credits belonging to it.

Duality.

We have referred to the authorities respecting duality of representation. There are numerous decisions delineating the equitable principles that govern.[10]

It will suffice to consider two decisions, namely, *Chelrob v. Barrett,* 57 N.E.2d 825 (N. Y. 1944), and *Overfield v. Pennroad Corporation,* 42 F. Supp. 586. These two contain a comprehensive discussion of the law and cite and review the leading cases. In both the courts took pains to declare the honesty and good faith of the officers, directors, and employees whose conduct was under review, and their firm belief in the propriety of their conduct. In both that honesty and good faith were said to be irrelevant and relief was granted.

The *Pennroad* case was a derivative suit by stockholders of Pennroad against the Pennsylvania Railroad. The complaint was that Pennroad's directors, in the management of its affairs, had not been solely guided by considerations affecting its welfare but had been, on the contrary, influenced by the interests of the Pennsylvania Railroad Company which had caused the Pennroad Corporation to be organized for the purpose of engaging in activities which it could not itself legally undertake. It appeared that the directors of the Pennroad Corporation were directors, officers or employees of the Pennsylvania Railroad, with a long history of loyalty to the latter company. It was held that this duality of obligation was sufficient ground for the recovery from Pennsylvania Railroad of all losses which had accrued to Pennroad as the result of investments made under the direction of these officers and directors, despite their unimpeachable integrity and good faith.[11]

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[10]For example, *Geddes v. Anaconda Copper Mining Co.,* 254 U.S. 590; *Merger Mines Corporation v. Grismer,* 137 F.2d 335 (9 Cir.), cer. den. 320 U.S. 794; *Goodell v. Verdugo Canon Water Co.,* 138 Cal. 308; 3 *Fletcher Cyc. Corporations,* Perm. ed., Sec. 961, p. 433 434; *Globe Woolen Company v. Utica Gas & Electric Co.,* 121 N.E. 378 (N.Y.) (Cardozo, J.); *Eshleman v. Keenan,* 187 Atl. 25, 2 A.2d 904 (Del.); *Price v. Standard Oil Co.,* 55 N.Y.S. 2d 890, a case where a corporation's employees were mere employees (not directors) of another corporation.

[11]In reaching this conclusion the court said:

"The occupation of two positions imposing different obligations at once raises a conflict of interest and duty and, due to the known

Chelrob v. Barrett, supra, involved a public utility system comprising three corporations: Long Island, Queens, and Nassau. Long Island owned the voting stock of Queens which owned the voting stock of Nassau. Queens expanded its plant to enable it to sell gas to Nassau. The price of the gas so sold was fixed by the directors of the two corporations, and all of them had been chosen by Long Island. A majority of the directors of Queens and of Nassau were also directors, and in some cases paid officers, of Long Island, and some of the directors of Long Island were also directors of Queens. Suit was brought by preferred stockholders of Queens who alleged that the price fixed by the directors was inadequate and unfair. Judgment was rendered directing additional payment to Queens.[12]

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weaknesses of human nature, it is to be expected that in a majority of cases duty would be the loser in the conflict. * * * As said by Justice Cardozo (Wendt v. Fischer, 243 N.Y. 439, 443, 154 N.E. 303, 304), 'The law "does not stop to inquire whether the contract or transaction was fair or unfair. It stops the inquiry when the relation is disclosed * * * without undertaking to deal with the question of abstract justice in the particular case." * * * *Only by this uncompromising rigidity has the rule of undivided loyalty been maintained against disintegrating erosion.'*

"The same Judge in Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545, 546, 62 A.L.R. 1, declared that 'many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. * * * Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd'." (p. 608).

[12]The court said (p. 834):

"* * * the transaction is subjected to judicial scrutiny because the price was fixed by corporate boards having common directors elected by Long Island and these directors had been placed in a position of divided loyalty.

"The rule that must be applied in such a situation has been stated by the Supreme Court of the United States. 'The relation of directors to corporations is of such a fiduciary nature that transactions between

The case is of further interest because the court noted that so long as Queens and Nassau earned enough to pay dividends on the preferred stock, it was not material what price was charged for the gas, since the earnings of either eventually reached the ultimate parent, Long Island, the owner of the common stock. The problem arose only when earnings fell off so that dividends on the preferred stock went into arrears. Thus, in the present case, it would be unimportant whether the tax savings went to the Company or the Corporation so long as the latter owned the former. The severance of that tie created the problem.

The principles of duality apply to every variety of situation where the same person or persons represent two or more interests —e.g., agency (Cf. *Restatement of Agency,* Sec. 390, 392), trusts (Cf. *Restatement of Trusts,* Sec. 170), attorneys at law (Cf. *Peyton v. William C. Peyton Corp.,* 7 A.2d 737, 747 (Del.)); *Re James Estate,* 86 N.Y.S. 2d 78 (1948). They were applied in *Bernheim v. Louisville Property Co.,* 214 S.W. 801 (Ky.), which is of particular interest because it involved common agents and officers of two corporations which had formerly been affiliated but whose interests had been severed. The court remarked on the failure of the individuals occupying dual positions to appreciate that "the severance of 1908 in reality changed the relationship between the two companies."

C. PLAINTIFF'S RIGHT TO RECOVER RESTS ON BENEFITS CONFERRED AND IS NOT CONFINED TO DETRIMENT SUSTAINED.

Fundamentally, the argument of defendant below, by which it seeks to retain unjustly the $17,000,000 benefit which it obtained by use of plaintiff's rights, was that plaintiff suffered no

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boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation, * * * Especially is this true where a common director is dominating in influence or in character. This court has been consistently emphatic in the application of this rule, which, it has declared, is founded in soundest morality, and we now add in the soundest business policy.' Geddes v. Anaconda Mining Co., 254 U.S. 590, 599, 41 S.Ct. 209, 212, 65 L. Ed. 425."

damage or detriment from defendant's appropriation of those rights. This is based on the fact that plaintiff itself happened to have no income in the years in question against which it could have offset its loss had defendant not utilized that loss to offset its own income. (See p. 52, supra.)

The argument is tantamount to the claim that because the plaintiff was poor and had no other income, anyone who could utilize its valuable rights could appropriate them without payment and with impunity. It is equivalent to saying that if a man should lose one leg and be possessed of a shoe that he could not use and that would fit only one other person in the community, that other person could take the shoe without payment. Or that if A is given a library of Sanskrit manuscripts and no one but B exists in the land who can read Sanskrit, B may take the library with impunity because A has "suffered no damage."

The short answer is that a plaintiff's rights in an unjust enrichment case are measured by the benefits conferred, received or taken—not by the detriment suffered. A plaintiff recovers because of benefits obtained by the defendant, and those benefits measure the recovery. *Restatement of Restitution,* Section 1, and comment. In the comment it is said:

> "Ordinarily the benefit to the one and the loss to the other are co-extensive, and the result of the remedies given under the rules stated in the Restatement of this Subject is to compel the one to surrender the benefit which he has received and thereby to make restitution to the other for the loss which he has suffered. * * * (p. 13)
>
> * * * * * * *
>
> "In other situations, a benefit has been received by the defendant but the plaintiff has not suffered a corresponding loss or, in some cases, any loss, but nevertheless the enrichment of the defendant would be unjust. In such cases, the defendant may be under a duty to give to the plaintiff the amount by which he has been enriched." (p. 14.)

Similarly, where a fiduciary gains a profit from the fiduciary relationship, it belongs to the beneficiary, regardless of whether

the latter could have made it independently.[13]

It is elementary, as said in 3 C.J.S., Sec. 165, p. 54, that the application of the fiduciary rules discussed at pp. 61-63, supra,

> "is not affected by the fact that the principal did not suffer any injury by reason of the agent's dealings * * *."

Or, as said in 3 *Scott on Trusts*, Sec. 502, page 2422:

> "It is immaterial that the profit was not made at the expense of the beneficiary or principal; * * *".

To the same effect are 2 *Scott*, p. 1098, and 54 *Am. Jur.* 249.

In *Fleishhacker v. Blum*, 109 F.2d 543 (9 Cir.), this Court held that the bank in whose behalf a stockholder's bill had been brought was entitled to recover certain profits "even though the bank has suffered no damage."

Such was the situation in the *Shreveport Bank* cases discussed at pp. 36-38, supra. There the Old Bank not being engaged in business, it would have had no tax on its stock, and therefore it had no occasion to use the value of its real property for its own tax benefit. Moreover, the New Bank's false representation to the State that the property belonged to it did not destroy the Old Bank's rights to use its property in any tax returns it might have to make.[14] Yet, as there said: "The fact that the Old Bank suffered no loss * * * makes no difference." *Leslie v. Commercial Nat. Bank of Shreveport*, 28 F. Supp. 927 at 933. In the first appeal in that case the dissenting judge commented: "The transaction left the old bank no worse off. It was not injured in the least by the transaction * * *." 144 F.2d at 245. Yet on the second appeal the same judge wrote the opinion of the court affirming the right

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[13]Restatement of Restitution, at p. 15 states:

> "So also, where a person in a fiduciary relation to another makes a profit in connection with transactions conducted by him as fiduciary, he is ordinarily accountable to his beneficiary for the profit, although the beneficiary suffered no loss."

[14]In the present case, the use by defendant of plaintiff's tax rights in consolidated returns legally precluded plaintiff from using the same tax credits in later separate returns.

of the old bank to recover such of the tax savings as were attributable to that class of property which it held belonged to the old bank.

In *Reading v. The King,* [1949] 2 K. B. 232, discussed at pp. 59-60, supra, the Crown was held entitled to bribes received by a soldier although it had sustained no loss and it could not itself have earned the sums involved.[15] The court held that the Crown could recover "whether or not [it] had suffered any detriment in fact"; and that the defendant "cannot be heard to say that * * * the plaintiff suffered no loss . The plaintiff, whether actually harmed or scathless, is conclusively presumed not only to have been damnified but to have been damnified to an extent measured by the amount" of defendant's enrichment.

In the *Consolidated Electric-Islands* case, discussed at p. 46, supra, losses of Islands, one of the affiliates, resulted in a tax saving to the affiliated system. The S.E.C. recognized that "none of this saving can be realized directly by Islands since it does not have the taxable net income against which to offset such losses" (13 S.E.C. at 652). While it was noted that the use of the loss for tax purposes might, in a future contingency, result in a tax liability to Islands, it was also noted that "any tax liability resulting to Islands * * * will be considerably less than the tax savings to be presently effected." Nevertheless, it was held proper that the whole of the tax savings should be paid to Islands by the other affiliates which achieved the savings by use of Islands' loss in consolidated tax returns.

A striking application of these rules of unjust enrichment will be found in the *Kentucky Cave* case, *Edwards v. Lee's Adm'r.*, 96 S.W.2d 1028 (Ky. 1936). There Edwards had discovered a cave the entrance to which was on his land. By years of advertising and exploitation he spread the fame of the cave, built a hotel near its mouth, improved the cave, and eventually secured a stream of

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[15]It is interesting to note that the sergeant's counsel recognized that under the law of "unjust enrichment" it was unnecessary that a plaintiff suffer damage, but he argued that "unjust enrichment", though a recognized part of American law, was not part of English law.

tourists whose entrance fees yielded him a good profit. Without his efforts the cave would have remained useless.

After the cave became profitable, a neighbor, Lee, sued on the ground that approximately ⅓ of the length of the cave underlay his land and recovered judgment requiring the defendant to account to the plaintiff for ⅓ of the net proceeds received by the defendant from exhibiting the cave over a space of 7 years, with 6% interest.

The Supreme Court of Kentucky affirmed the judgment although it recognized (1) that plaintiff merely had a hole in the ground which he himself could not use because it was so far beneath the surface that it could not be entered except through the natural mouth on defendant's property; (2) that the cave was therefore of no practical use to the plaintiff; (3) that for the same reason there was no one in the world other than defendant himself upon whom the plaintiff might confer a right of beneficial use of the portion of the cave under his property; (4) that consequently plaintiff's portion of the cave had no utility to him, it had no sales or rental value, and plaintiff had not been ousted of the physical occupation or use of his property because he could not and did not occupy it; (5) that the property had not in any way been injured by the use to which defendant had put it, and (6) that plaintiff had suffered no loss or detriment.

The court stated that, as the case was *sui generis,* it was left to fundamental principles and analogies. It reasoned (1) that plaintiff had something (a definite segment of the cave) and therefore was possessed of a right which it was the policy of the law to protect; (2) that the action was in equity for an accounting; and (3) that the "measure of recovery in this case must be the benefits, or net profits, received by the appellants from the use of the property of appellees," by way of analogy to the rule of Section 136 of the *Restatement of Restitution.*

The court refused to treat the case as one of trespass, for the reason that, had it done so, there could be no recovery for lack of "damage"; the property had not been injured, and there was

no rental value since plaintiff had no access to the cave, could not use it, and there was no ouster of possession.

In the present case, bearing in mind that the defendant simply appropriated the plaintiff's tax credits without discussion and without any consideration for the existence or rights of the plaintiff, Section 136 of the *Restatement,* relating to benefits tortiously acquired, is also applicable. In the comment under that section, it is said:

> "In some cases, however, no harm is done and in these cases if the sole remedy were by an action of tort the wrongdoer would be allowed to profit at little or no expense. * * * The usual method of seeking restitution is by a bill in equity with a request for an accounting for any profits which have been received * * *." (p. 553)

Even where a defendant has not acted in a manner that is considered to be tortious, he may have to account under the principles of quasi-contract. *Restatement of Restitution,* Ch. 6. The law on the subject is not static or confined to ancient categories.[16]

In *Truncale v. Universal Pictures Co.,* 76 F. Supp. 465, directors of a corporation held options to buy from it shares of its stock at a fixed price. Under tax law and regulations, if such an option is exercised at a time when the market price exceeds the option price, the excess is taxable income, but the corporation may deduct the excess in computing its own tax. In order to secure a closing agreement from the Commissioner of Internal Revenue that the excess, in the event the options should thereafter be exercised, would not constitute taxable income to the directors, the latter caused the corporation to agree with the Commissioner that in computing its own income it would not deduct the excess.

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[16] As said in the *Restatement,* at page 493:

> "The situations dealt with in this Chapter do not exhaust all those in which restitution can conceivably be granted for benefits lawfully acquired. They represent situations which have arisen, and indicate the type of situations in which restitution should be granted."

Closing agreements to this effect were executed, and the options were then exercised.

As a consequence, the corporation paid more taxes than it should have, and the tax liabilities of the directors were diminished. However, the losses suffered by the corporation were much less than the gains enjoyed by the directors, since each director had his own outside income and the amount of his tax savings was affected by his own tax bracket.

A stockholder's derivative action was brought against the directors to compel them to account to the corporation not merely for the amount of the losses suffered by it, but for the entire tax savings of the directors. Defendants moved for a summary judgment on the ground of the statute of limitations. This turned, under New York statutes, on whether recovery was limited to the loss suffered by the corporation or extended to the entire gain enjoyed by the defendants. The court (Rifkind, J.) held the latter. Remarking that the situation was unique, it said (p. 469):

> "* * * where a corporation has the freedom to do an act or to refrain, the doing of the act, enabling others to derive benefits in excess of the losses suffered by the corporation, has a 'sale' value of which the ceiling is the amount of such benefits; * * *."

Plaintiff's rights here are far stronger than that of the corporation in *Truncale's* case. There the corporation had nothing to contribute, and possessed nothing, other than the power to refuse to enter into the closing agreement. Here plaintiff possessed not only the power to decline to enter into consolidated returns, but by entering into such returns it contributed something that belonged to itself, to wit, its own tax credits worth $17,000,000.

Closely related to defendant's argument that plaintiff was not damaged is its argument that plaintiff's tax credits could not be sold generally to those desirous of making tax savings. From this fact it argues that plaintiff has no right of recovery.

It is true that the plaintiff's loss could be used to offset income of someone other than itself only in a consolidated return and therefore could be availed of only by defendant or another of the affiliates. But the fact is irrelevant.

Thus in the *Shreveport Bank* cases, supra, only the new bank was able to make use of the tax credit. In *Truncale v. Universal Film Exchange,* supra, no one but the directors were able to make use of their corporation's situation. In the absence of utilization by them the corporation could not have realized the benefits which they received. In the *Kentucky Cave* case, in all the world only the defendant could make use of plaintiff's part of the "hole in the ground".

The fact, then, that a particular asset or right has a limited utility or "market", or that no one can use it except one party, does not destroy its value or give that party the right to appropriate it without incurring liability.

For example, the government may be the only possible buyer f a given property and unless it sees fit to buy, the owner may ave no way to utilize the property or to realize upon it. But that act does not destroy its value. In *James v. Campbell,* 104 U.S. 56, 358, the court noted that "Many inventions relate to subjects hich can only be properly used by the government, such as ex-losive shells, rams, and submarine batteries to be attached to rmed vessels," but observed that the government could not use ich patented inventions or the patents without paying just com-ensation.

In the field of eminent domain generally, the fact that property as no general market and that therefore there is no market value oes not eliminate its value. As said in *San Diego Land etc. Co. Neale,* 78 Cal. 63, 68,

> "But it is certain that a corporation could not for that reason appropriate it for nothing."

nd as said in *Boom Co. v. Patterson,* 98 U.S. 403 at 408:

> "Property is not to be * * * regarded as valueless because he [the owner] is unable to put it to any use. Others may be able to use it, * * *."

In the patent field many an invention consists of an improvement or addition to a machine or process on which another owns the patents, and it has no utility except as part of that machine or process, so that no one except the owner of the machine or process can make economic use of it. Yet the latter cannot appropriate the new invention without paying for it. As said in *Bigelow v. R.K.O. Radio Pictures,* 327 U.S. 251, 265, if "a wrongdoer has incorporated the subject of a plaintiff's patent or trademark in a single product to which the defendant has contributed other elements of value or utility, and has derived profits from the sale of the product," not only must he pay but he may have to account for all his profits. Cf. *Westinghouse Co. v. Wagner Mfg. Co.,* 225 U.S. 604.

Defendant has argued that what plaintiff had was a loss, that a loss is a "negative" thing, that it cannot be called an "asset", and that therefore plaintiff has no right of recovery.

Plaintiff not only had the loss, it had the right to make use of it for tax purposes and the right to permit or withhold consent to its use in consolidated returns. It is of no relevance whether plaintiff's $75,000,000 loss, its right of use, or its right to withhold consent to the use of a consolidated return whereby the loss could be utilized, can be denominated "property." Terminology, such as "property," is not the source of legal or equitable rights. The reverse is true: in the long history of Anglo-American law the recognition that a right exists and its entitled to legal protection has been the starting point of recognition of new kinds of property rights.

In *U.S. v. Willow River Co.,* 324 U.S. 499, a plaintiff claimed a right to recover by denominating something as "property". The court said (at p. 502): "We cannot start the process of decision by calling such a claim as we have here a 'property right'; whether it is a property right is really the question to be answered."

It is equally question-begging to try to defeat a recovery by asserting that there is no property right involved.[17]

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[17]In *Matarese v. Moore-McCormack Lines,* 158 F.2d 631 (2 Cir.), defendant made use of an idea of the plaintiff. The idea was not only an in

As was said in the recent case of *Johnston v. 20th Century-Fox Film Corp.*, 82 C.A.2d 796, 817:

> "As society has developed there has been a corresponding evolution in the development of property rights. Matters considered as near revolutionary a few years ago are now accepted as facts. Legal history shows a continual recognition of new interests and a gradual willingness to protect interests in intangible things. (Warren & Brandeis, 4 Harv. L. Rev. 193; 4 Ford. L. Rev. 307; 45 Yale L. J. 520)".

The famous article of Mr. Louis Brandeis (later Mr. Justice Brandeis) and Mr. Samuel Warren just referred to, which first appeared in 4 Harvard Law Review in 1890, entitled "The Right to Privacy", contains a masterly discussion of the subject. (See particularly pp. 193 to 195, and p. 212).[18]

In the present case, whatever it may be denominated or however it may be characterized, the loss was plaintiff's, it carried with it the right of use in certain situations to achieve tax savings, and that right belonged to plaintiff. Defendant appropriated that right and thereby achieved a $17,000,000 saving, and it should now account to plaintiff.

The principles on which plaintiff is entitled to recovery are not novel; they are fundamental. All that is novel in the case is the unique factual situation. But equity is not powerless to cope with unusual facts.

The Right to Recover Does Not Require a Contract.

At pages 53, 54, supra, we showed that an agreement concerning the equitable apportionment of the tax savings would

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tangible, it was unpatentable. Thus plaintiff had no "property right". Defendant was compelled to account for the savings it achieved in the cost of doing longshore work resulting from the use of the idea.

[18]As was stated by Chief Justice Shaw of Massachusetts (in *Boston and Lowell Railroad Corporation v. Salem and Lowell Railroad Co., et al.*, 2 Gray (68 Mass.) 1, 35 (1854)), the term "property"

> "is *nomen generalissimum,* and extends to every species of valuable right and interest, and includes real and personal property, easements, franchises and incorporeal hereditaments."

have been perfectly valid. But plaintiff's rights to recover do not depend on whether such an agreement was or could have been made.

As said in 2 *Bouvier's Law Dictionary,* 803 (Rawle's Revision), under "Quasi-contracts":

> "In quasi-contract the obligation arises not from consent, as in the case of contracts, but from the law or natural equity."[19]

In *Reading v. The King* [1949], 2 K. B. 232, discussed at pp 59, 60, supra, no valid prior contract to share bribes would have been possible. In the *Shreveport Bank* cases, discussed at pp. 36, 38, supra, no valid contract would have been possible between the Old Bank and the New Bank to report the former's property as the latter's in order to save taxes.

And as we shall show, at pages 84-86, infra, a fiduciary must account to his beneficiary for his gains even though made in an illegal enterprise. Yet a prior agreement on the subject would not be permissible.

II.

THE TRIAL COURT'S REASONS FOR DENYING RELIEF TO PLAINTIFF ARE ERRONEOUS

The court's reasons for denying relief to plaintiff have nothing in common with defendant's arguments for denial of relief. Indeed, the principal ground of the court's decision is offensive to

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[19]In *Matarese v. Moore-McCormack Lines,* 158 F.2d 631 (2 Cir.) "The doctrine of unjust enrichment or recovery in quasi-contract obviously does not deal with situations in which the party to be charged has by word or deed legally consented to assume a duty toward the party seeking to charge him. Instead, it applies to situations where as a matter of fact there is no legal contract, but where the person sought to be charged is in possession of money or property which in good conscience and justice he should not retain, but should deliver to another. * * * Where this is true the courts impose a duty to refund the money or the use value of the property to the person to whom in good conscience it ought to belong." (p. 634.)

defendant, for it is tantamount to accusing it of improper conduct that should be investigated.[20]

The court based its decision on two lines of reasoning, a major ground and a minor. The major one was its belief that the tax savings ought not to have been allowed by the Treasury. The minor one was the view that plaintiff was seeking to obtain something denied it under the Reorganization Plan.

These two bases on which the court has denied relief to plaintiff are mutually inconsistent. In the first place, they are bottomed on incompatible attitudes toward the court's own power and its exercise. In denying relief on its second line of reasoning the court does so on the ground that it ought not to go behind final administrative and judicial determinations. Truly, it ought not. But in denying relief on the ground that the tax savings should not have been allowed by the Treasury, the court has in fact done exactly that: it has gone behind a final administrative determination. Yet in the situation to which it would apply the principle that it should not do so, the principle has no application, for a judgment for plaintiff would have no such effect, as we show at pages 88-5, infra.

The two lines of reasoning are incompatible for another reason. In one breath the court asserts that the tax savings were "amazing and undeserved", that the tax should have been paid to the Treasury, and that it would order defendant to pay the 17,000,000 to the Treasury, if it had the power to do so. In the next breath, it asserts that payment of these very moneys to plaintiff will militate against the "resuscitation" of the defendant railroad and thus defeat the Reorganization Plan. Yet the first observation recognizes that the "resuscitation" of this railroad did not involve the retention of these moneys by defendant.

Neither of the District Court's two lines of reasoning is sound, as we now proceed to show.

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[20]Thus the Court said in its opinion that the tax saving "invites a type of scrutiny which this Court is powerless to give it." (270)

A. IT WAS IMPROPER TO DENY RELIEF TO PLAINTIFF ON THE BELIEF THAT THE TAX SAVING OUGHT NOT TO HAVE BEEN ALLOWED BY THE TREASURY.

We commented on this reasoning at p. 47, supra. As we there said, for defendant Company to keep the tax saving would be a subversion of the tax law. The trial court believed that *defendant* had wronged the government. Yet, for that reason it has denied recovery to the plaintiff and thereby has rewarded the defendant by permitting it to keep the gain. This is contrary to the maxim, "No one can take advantage of his own wrong." *Cal. Civil Code,* Sec. 3517.

There are several evident inadequacies in the trial court's conclusion, each sufficient to invalidate it:

(1) The tax deductions were in accord with law.

(2) The allowability of the tax deductions was not an issue in the case and was not open to question here.

(3) Even if the deductions should not have been allowed, that fact does not justify denial of an accounting by defendant to plaintiff.

The Tax Procedure and Deductions Were in Accord with the Law.

In the first place, the conclusion that the filing of consolidated returns and the use of plaintiff's loss to offset defendant's income were not permitted by tax law and regulations, as respects the government, is not sound.

The rational basis of allowing consolidated returns is the existence of an economic entity. But, in providing for the situation, Congress chose to establish certain ready and less subjective tests. Corporations are "affilitated" when 95% of the voting power of all classes of stock and 95% of each class of non-voting stock, except limited preferred stock, are owned by one or more of the corporations in the group. Internal Revenue Code, Sec. 141. Plaintiff and defendant were affiliated within that statutory test until April 30, 1944. And Section 23(g)(4) of the Internal Revenue Code permitted a parent's loss resulting from worthlessness of stockholdings to be used as a deduction. The regulations also

permitted consolidated returns to be filed although one or more affiliates were in bankruptcy (see p. 43, supra).

The statutory tests for tax deductions existing, they govern, and the courts do not go behind them.[21] For example, in *Trinity Buildings Corporation of New York,* 40 B.T.A. 1315, one of an affiliated group of corporations was in bankruptcy, and thereby its control was out of the hands of the parent. The trustee refused to join in consolidated returns. Under the regulations all affiliates must join, and the Commissioner therefore refused to recognize a consolidated return joined in only by the others. He was upheld, the Board of Tax Appeals saying:

> "Looking alone, therefore, at section 52 and section 141, it seems clear that the bankrupt corporation was, by reason of the Realty Co.'s ownership of its shares, a member of the affiliated group * * * and that this is none the less so because the shares of the bankrupt corporation may have been worthless or because its business and properties were being operated by a trustee in bankruptcy." (p. 1319)

George A. Fuller Co. v. Commissioner of Internal Revenue, 92 F.2d 72 (2 Cir.), involved the same question for the same group of corporations for another year. The Court arrived at the same decision as the Board in the *Trinity* case.[22]

Whether the Tax Saving Should Have Been Allowed by the Treasury Was No Issue in This Case.

In the second place, whether the tax savings should have been allowed by the Bureau of Internal Revenue was not an issue in

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[21]*Commissioner v. Korell,* 339 U.S. (prelim. print.) 619, 625, 626.

[22]It said:

> "Though it is clear that there was no actual compliance with the condition imposed by the statute [joinder by all affiliates] the petitioner insists that where the failure to comply is due to the refusal of a trustee of one of the group in bankruptcy whose action is, therefore, not subject to the common control which might otherwise prevail a consolidated return may properly be filed for the remainder of the group.
>
> "The plain answer to such a contention is that it is contrary to the statute." (p. 73.)

the case, and the court below had no right to question it. This case *starts* with the fact that there *were* tax savings. Their *existence* is part of the factual context of this litigation. The sole issue was who is entitled to the tax savings as between plaintiff and defendant.

Here a federal tax question had been determined by the proper administrative officials, and the determination and tax settlement had become final before the judgment was entered below and no longer could be questioned by the government (see p. 23, supra). The Bureau of Internal Revenue, not the court, was the instrumentality selected by Congress for the purpose. In *Bull v. United States,* 295 U.S. 247, 259, the Supreme Court said:

> "The statute prescribes the rule of taxation. Some machinery must be provided for applying the rule to the facts in each taxpayer's case, in order to ascertain the amount due. The chosen instrumentality for the purpose is an administrative agency whose action is called an assessment. The assessment * * * may include the calculation and fix the amount of tax payable, and assessments of federal estate and income taxes are of this type."

The tax laws authorize the Commissioner to enter into compromises. And as said by the Attorney General (31 Op. Atty. Gen. 459), it is *his* power to do so "where, in *his* judgment, such compromises were for the interests of the United States."

A determination by the instrumentality chosen by Congress to make it is not lightly to be questioned, even in case of a direct attack. As said in *In Re Epstein,* 4 F.2d 529, 530 (6 Cir.), "courts do not lightly set aside a construction, by a department of the government, of a statute peculiarly relating to the duties and powers of that department * * *" And in *U. S. v. Pierce Auto Lines,* 327 U.S. 515, an appeal from a decision of a three-judge district court suspending an order of the Interstate Commerce Commission, the court said:

> "We think the court misconceived not only the effects of the Commission's action * * * but also its own function. It is not true, as the opinion stated, that * * * 'the courts must

in a litigated case, be the arbiters of the paramount public interest.' This is rather the business of the Commission, made such by the very terms of the statute." (p. 535)

Such is the law in case of a direct attack. Where the attack is ıot direct but merely collateral, arising in a different kind of awsuit merely because the results of the tax determination are nvolved as one of the facts of the case, no court can question he propriety of the determination. Cf. *In re Kaufman's Estate,* 0 N.Y.S. 2d 616; *In re Mayer's Estate,* 22 N.Y.S. 2d 468.

In the present case there was not even a collateral attack, nuch less a direct one, for neither plaintiff nor defendant has juestioned the tax determination.

If settlement had not been effected with the Commissioner but he matter had been litigated through the Tax Court, and if that ourt had decided in favor of the tax deduction here involved and ts decision had been allowed to become final, certainly the court elow could not in this case have questioned the adjudication for ny purpose whatever. No more can it do so now.

Indeed, an income tax "assessment is given the force of a judgnent." *Bull v. United States,* supra, at p. 260.

In *Galbraith v. Devlin,* 148 Pac. 589 (Wash.), an action for an ccounting by one partner was instituted against others. One deense was that the plaintiff did not have clean hands because he ad made certain misrepresentations to one who was collaterally nterested in the transaction. The court held for the plaintiff. It aid (p. 592):

"If Harvey was satisfied, no one else can complain for him."[23]

Further, the procedure of tax settlement was legal in every egard. Full disclosure was made to the Bureau of Internal Reve-

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[23]Cf. *Langley v. Devlin,* 163 Pac. 395 (Wash.), where a defendant re-sted an action for an accounting on the ground that a third party had en wronged. The court said, "The third party is not complaining." It rther said that for a court of equity to deny relief, "because of a fraud fecting a third party or a right 'would lead to the absurd consequence at a defendant in a suit would take a decree equivalent in its legal force affirmative relief under the plea of corrupt participation'." (p. 401.)

nue in great detail. In May 1946, Polk, the tax counsel, wrote the first "Krigbaum letter" to the Internal Revenue Agent in Charge which explained exactly how the loss occurred (1779 P 64). It stated the facts showing the severance of the economic unity between plaintiff and defendant and the dates. A year later he wrote the second Krigbaum letter (1799 P 71).

The Treasury's audit and examination of the tax returns took over a year and a half (1419, 1788). Negotiations for settlement extended over six months. They occurred first with the agent in charge, and then with the Commissioner of Internal Revenue in Washington where several conferences were held, presided over by the technical adviser to the Commissioner. The history is reviewed in the record at pages 1788-91, in plaintiff's Exhibit 68. Indeed, when Polk sought on the witness stand to give a full review of the negotiations with the government, he was shut off by the trial court of its own motion with the remark,

> "I just can't see what purpose is served by these long discussions as to what took place in a conference in Washington over subject matter where the results are before the court, and it doesn't seem to serve any useful purpose." (1428)

This observation during the trial was sound. The court should never have departed from it.

For the trial court in this case to refuse to inquire into the merits of the case *as between plaintiff and defendant* because of a belief that the tax settlement was "phony", as the court expressed it (423), was, we submit, not permissible.

Even if the Tax Deductions Were Improper, That Would Be No Reason to Deny Relief to Plaintiff.

The reasoning on the basis of which the court below denied plaintiff an accounting because of its belief that the government should not have allowed the tax deductions is so elusive that it is difficult to find the legal category in which to appraise it or by which to test its soundness. But no matter how viewed, it is still unsound.

If the trial court had in mind that a court will not intervene between two joint wrongdoers, that doctrine has no application to the facts of this case. The tax matter was handled by defendant and its counsel in its entirety, and plaintiff was not a participant in the handling of the tax returns and the settlement. The court so found (see pp. 8, 9, supra), and during the settlement of the findings it stated what it meant by its findings on this score as the following colloquy shows:

> "Mr. Lasky: * * * Your Honor's opinion in major part, as we understand it, decided the case on the basis that the taxes ought to have been paid the government; that the settlement, to quote from the opinion, 'invited a type of scrutiny that the court could not give it,' and that if you were able to do so, you would set it aside. 'The tax escape was erroneous and unjust.' More of that quotation. And consequently, the court of equity would decline to interevene.
>
> "As has been indicated so far this afternoon, that sounds on the principle that the court will not interfere between wrongdoers, or possibly like the doctrine of unclean hands.
>
> "So the first group of requested findings, three, four, five, six, seven and nine are directed to this. In essence, they go to the fact that the plaintiff is not in pari delicto; that the plaintiff did not itself conduct the tax transaction.
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> "* * * This merely goes to the point that the plaintiff itself did not conduct the tax operations, had nothing to do with them until the time of settlement, so that if there is some wrongdoing involved there we were not in pari delicto on it. The facts we present are all true." (462)
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> * * * * * * *
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> "* * * the tax settlement was conducted by defendants' tax counsel, so that the plaintiff itself, if there were any impropriety, if there were wrongdoing, if this doctrine of unclean hands applies, then we do not come in; we were not in pari delicto." (465)
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> * * * * * * *
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> "* * * the evidence certainly discloses that the tax operations, however they may be characterized, were conducted by the defendant and its tax counsel, not by the plaintiff.
>
> "The Court: There is no question about that." (468)
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> * * * * * * *

> "The Court: Don't you think that most everything you have mentioned is really in the opinion some place or another? You are right, perhaps in proposing it in orderly concise form." (476)

It is a settled rule of equity that if one person uses property or rights of another to make a profit, particularly if he is a fiduciary, the other person—owner or beneficiary—is entitled to the profits even though they have emanated from an illegal or improper enterprise in which the property or rights were embarked. The fiduciary cannot escape accounting on the plea of illegality of the enterprise.

Thus in *Barney v. Saunders, et al.,* 16 How (U.S.) 534, the Supreme Court reversed a judgment that refused to compel trustees to account for usurious interest received. It said:

> "They cannot be allowed to aver that the profits made on the trust fund should be put in their own pockets, because they were unlawful gains, for fear that the conscience of the cestui que trust should be defiled by participation in them. To indulge trustees in such an obliquity of conscience, would be holding out immunity for misconduct and an inducement to speculate with the trust funds, and put them in peril." (p. 543)

In the *Shreveport Bank* case, discussed at pp. 36-38, supra, the new bank used as tax deductions for state tax purposes certain property belonging to the old bank. In achieving its tax deductions the new bank made false reports to the state, that is to say, it reported and represented that the property was its own. Its tax savings thus rested on a false statement of fact. Had the truth been reported, the state would not have allowed the deductions, as the district court stated (28 F. Supp. 927, 933). Consequently, on the first appeal (144 F.2d 231) Judge Waller dissented from the decision that the new bank must account to the old bank for the tax savings. His opinion expressed all the views that permeate the opinion of the court below in the present case. He said (p. 245):

"As a result of the shrewdness of the new bank, plus the stupidity, or cupidity, of the taxing authorities, the new bank was allowed to take a deduction in its capital stock assessment to the same extent as if it had been the real owner of the old bank's real estate. * * *

"All parties seem to have proceeded on the theory that it was all right to gyp the State of Louisiana but some think it wrong to gyp the old bank."

Yet on the second appeal Judge Waller wrote the opinion of the entire court en banc upholding the old bank's right to recover. *A fortiori,* the plaintiff should recover here. In the *Shreveport* case, the tax deduction was based upon a false statement of fact. Here there were no false statements to the tax authorities. The latter knew the facts, and the court below believes merely that the legal conclusions of the tax authorities as to the tax consequences were erroneous.

In *Reading v. The King,* discussed at pages 59-60, supra, the Crown was held entitled to moneys received by an army sergeant for bribes received in assisting violations of the law of Egypt. Patently the profits resulted from an illegal enterprise, and the Crown itself could not have engaged in that enterprise. The court held that illegality was no bar to the Crown's rights. It held that the law did not imply a promise "in advance of the event by the soldier to hand over any price which he might receive, which would be invalid for illegality, but a promise made, after the price had been received * * * to hand the amount of the price over."

This is in accord with what Mr. Justice Story said in 3 *Story's Equity Jurisprudence* (14th Ed.) Sec. 1663, p. 303:

"One of the most common cases in which a Court of Equity acts upon the ground of implied trusts in invitum is where a party has received money which he cannot conscientiously withhold from another party. It has been well remarked that the receiving of money which consistently with conscience cannot be retained is in equity sufficient to raise a trust in favor of the party for whom or on whose account it was received. This is the governing principle in

> all such cases. And therefore whenever any interest arises, the true question is, not whether money has been received by a party of which he could not have compelled the payment, but whether he can now, with a safe conscience, ex aequo et bono retain it."

Here, the question is not whether defendant could properly achieve the tax savings. It *has* achieved them, and the question is whether it may now retain them vis-a-vis the plaintiff.

In *Daniel v. Daniel,* 198 Pac. 728 (Wash), the owner of an undivided interest in property sued for an accounting of profits. Defendant resisted on the ground that most of the profits came from leasing the premises for purposes of prostitution. The court noted a division in the authorities as to the right to enforce a sharing of profits from an illegal enterprise, as between the participants, but said that the factual situation was different.

> "We cannot, however, concede that the present case falls within the rule sought to be invoked. The respondent was in this instance in no sense a party or privy to the illegal transaction through which the profits she seeks to recover were gained. At the time they were gained the appellant was holding and managing the property as his own, without recognition of any right therein in the respondent, and it was wholly because of his individual act that the property was put to an immoral use. To require him to account for the profits gained is not, therefore, to enforce an illegal transaction to which the respondent was at one time a party; it is but to require him to account for money acquired by the wrongful use of her property. To refuse to require the accounting would be to punish the innocent, rather than the guilty party, and this is not the purpose of the rule relied upon. Its purpose is to discourage illegal transactions and, when this purpose is better subserved by recognizing and enforcing the transaction than it is by ignoring it courts have never hesitated so to do." (p. 730)

And see *McBlair v. Gibbes,* 17 How. (U.S.) 232.[24]

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[24]See also, in *Memphis & Arkansas City Packet Co. v. Agnew,* 17 S.W. 949 (Tenn.). There the defendant was the captain of plaintiff

In denying the plaintiff recovery because it felt that the taxes should have been paid to the government, the court here was simply applying its own personal notion of public policy. As said in *Stephens v. Southern Pacific Co.*, 109 Cal. 86, 89 "* * * public policy is an unruly horse, astride of which you are carried into unknown and uncertain paths * * *". And other courts have said that a judge does not have "any jurisdiction to bring into the discussion his own views of what he may consider an expedient thing in his own peculiar view of public policy."[25]

And in another context Mr. Justice Holmes in *Southern Pacific Co. v. Jensen,* 244 U.S. 205 at 220, commented that "there is no gratuity" about granting relief by a court of equity. "If the claim is enforced or recognized it is because the claim is a right * * *"

We submit that the trial court's sense of outrage that the tax authorities permitted the tax deductions was a false element in this case.

The District Court Did Not Apply Its Own Theory Consistently.

The District Court's theory was that it should "leave the parties where they are" (276). But its decision fails to do even that.

As we have seen (p. 24, supra), in August 1947 a stipulation of the parties and a pre-trial order of the court provided that for

hip. Over a period of years he purchased and sold cotton seed and other products at various landings without plaintiff's knowledge by using its name, money, credit and employees. In a suit by plaintiff for an accounting of profits, defendant set up the defenses that the plaintiff was not qualified to do business in Tennessee and was doing business in violation of the law, and that the transactions would have been ultra vires the plaintiff's corporate powers. In granting relief to the plantiff the court said that no cases could be found to justify denying relief, and "it would be a reproach to the law if they could." It further said:

> "There is more than one phase to sound public policy. One of these that ought to be paramount is that courts should close their ears when dishonest men attempt to rest on rules of law in an effort to shield them from the consequences of their misdeeds." (p. 951.)

[25]Quoted in *In re Rahn's Estate,* 291 S.W. 120, 124 (Mo.) which reversed a lower court and contains a comprehensive review of the subject of public policy.

the purposes of this case $3,385,290 should be deemed to have been paid by the Treasury to plaintiff, as a partial refund of 1942 taxes, and placed in the custody of the court to await judgment.

On the District Court's theory, the decree should have been framed so as to give effect to the mandate of this pre-trial order that plaintiff have possession of the $3,385,290.[26]

There is, moreover, an estoppel. Although the court below finally denied relief to plaintiff on the view that the tax settlement was "phony", it knew of that settlement, reviewed it, and made its pre-trial order about it, all before it was final and binding. Under the settlement the claim for refund was not withdrawn; it was merely rejected by the Treasury on August 26, 1947. Either the Treasury or the taxpayer could have ignored the settlement, the Treasury by imposing a deficiency assessment, the plaintiff by suing for a refund. (*Botany Worsted Mills v. United States,* 278 U.S. 282) The statute of limitations did not run against a suit by plaintiff until two years after rejection of the claim (I.R.C., Sec. 3772, subd. 2). That was just eleven days before the court below rendered its opinion. Had plaintiff not been lulled by the stipulation and the pre-trial order, it could have prevented the running of the statute.

B. PLAINTIFF IS NOT SEEKING TO GO BEHIND THE REORGANIZATION PLAN.

The second ground of the trial court's decision was its belief that plaintiff was not really seeking to share in the tax savings but was "circuitously" trying to obtain "something in the nature of equity or value" for its former ownership of the defendant and that a judgment for plaintiff would in effect go behind the reorganization plan and thereby "modify the administrative and judicial judgments in the reorganization proceeding" and be inconsistent with the "philosophy underlying Section 77 of the

[26]After the District Court announced its decision, this aspect of the case was called to its attention by proposed findings of fact and conclusion of law (277-278) and by argument on the settlement of findings (439 et seq.).

Bankruptcy Act" which was designed for "resuscitating" "sick and ailing railroads" (272-273).

This reasoning, we submit, simply has no substance.

Plaintiff's claim is not remotely in derogation of the plan of reorganization. And in asking that the benefit of the tax savings be adjudged to belong to it, plaintiff does not at all seek to undo the plan but accepts its consequences in full. The full and utmost consummation of the plan *is not the end, but only the threshhold, of this case.*

The tax savings arose *after* the plan was fully consummated. And it was the *fulfillment* of the plan—the very fact of its full and complete consummation—that created the factual situation which made the *later* tax savings possible. The plan was drastic. It wiped out the entire stock ownership of the old stockholder. Of this deprivation no complaint is made in the present suit and no relief against it is here sought. But the consummation of the plan, having stripped the plaintiff of that ownership, left plaintiff with something in its place—a huge loss and a right to utilize it for tax purposes.

It was then that defendant went beyond the plan and seized what plaintiff had left—its loss and right—to fatten its surplus by an additional $17,000,000.

It was no part of the plan that this be done. Not only were the claim for refund and the 1944 returns filed after the defendant was out of reorganization, but the plan could not have commanded any such consequence even had it purported to do so. (See discussion at p. 52, supra, and *Callaway v. Benton,* 336 U.S. 132.)

The tax savings here involved had no bearing on the type of reorganization. They were unexpected—in the words of defendant's counsel below, "fortuitous." Indeed, the amendment to the Revenue Act which for the first time permitted the use of the stock loss to offset ordinary income and thus made possible the saving here was not enacted until October 1942 (Revenue Act of 1942, Sec. 123(a)).

The plan fully contemplated that the reorganized defendant company should pay its income taxes. It explicitly stated (233 I.C.C. at 455) that

> "Notwithstanding any other provisions of this modified order, the reorganized company shall assume the liability for, and shall pay in full in due course, any and all taxes due to the United States from the debtor or the debtor's trustees for any taxable period prior to the date of the confirmation of the plan * * *"

The "revesting order" of November 27, 1944 (see p. 26, supra), by which the properties were restored to defendant and freed of bankruptcy administration, provided in paragraph 9 that defendant must

> "assume liability for, and pay in due course, any and all taxes lawfully due to the United States from the debtor or the debtor's Trustees for any taxable period prior to January 1, 1945 * * *." (36 at 49.)

In consideration of the transfer to it by the trustees of all assets in their hands, the defendant executed an "Agreement of Assumption" on December 14, 1944, effective December 29, 1944, in the form authorized by the revesting order (1711 P 15). Thereby defendant specifically agreed to

> "assume the liability for, and pay in due course, any and all taxes lawfully due to the United States from the debtor or the debtor's Trustees for any taxable period prior to January 1, 1945 * * *." (1716)

The defendant thus assumed the liability to pay the federal taxes. And it proceeded to make provision to do so. It did pay the taxes for 1942, it made monthly accruals to pay them for 1943 and 1944, and it set aside reserves of $10,100,000 for that purpose (see p. 27, supra). As late as August 1944, the trustees reported to the bankruptcy court that, after the deduction of the $7,100,000 reserve fund for 1943 taxes, the 1943 earnings were so large as to leave nearly $9,000,000 available for dividends on the common stock, in addition to over $11,500,000 required to carry out the provisions of the plan (2179 at 2188 D23 A).

This tax liability, which it was bound by the plan to pay and for which it had made cash provision, it later discharged,—not with the cash which it had set aside and which it still had available for the purpose and which it yet has but by the use of plaintiff's tax credits, which the Treasury accepted in August 1947.

We do not contend that the provisions of the Plan and Revesting Order quoted above, by which defendant was required to pay federal taxes, created the duty to pay anything to plaintiff. We refer to these provisions for a different reason: As they show, the Plan contemplated that defendant should pay its taxes and did not contemplate that it should retain the moneys required to discharge its tax liabilities. Those moneys would have been paid into the United States Treasury were it not for the subsequent appropriation by the trustees and the defendant of the plaintiff's credits—a result not even faintly imagined by the authors of the Plan or by the court which approved it.

Plaintiff's rights are based on principles of equity and quasi-contract, which became operative by reason of that subsequent appropriation and use. The trustees, being officers of a court, were particularly bound by those principles, for courts compel their officers to account, under principles of unjust enrichment, for benefits received even in circumstances where a less stringent standard of accountability might be applicable to the acts of private parties. *Glenn on Liquidation,* p. 833; *Carpenter v. Southworth,* 165 Fed. 428; *Gillig v. Grant,* 49 N.Y.S. 78, 81; *Standard Oil Co. v. Hawkins,* 74 Fed. 395, cited in *In re Berry,* 147 Fed. 208, 211 (2 Cir.).

The purpose of any bankruptcy proceeding is to discharge or scale down debts existing on and prior to the onset of the bankruptcy, not to discharge obligations arising during the bankruptcy from the operations of the court's officers. The full satisfaction of obligations arising from their acts is always protected. Here the onset of the bankruptcy was 1935, and the effective date of the plan of reorganization was January 1, 1939 (233 I.C.C. 412). The plan required, in paragraph Q, that

> "current liabilities and obligations incurred by the trustees of the properties of the debtor during the reorganization proceedings * * * shall be paid in cash or assumed by the reorganized company * * *." (233 I.C.C. at 452)

The defendant did assume the obligations arising from the trustees' conduct of the business. In addition to assuming the liability to pay taxes, as noted at page 90 above, it agreed by paragraph 2 of the Assumption Agreement to

> "assume any and all outstanding current liabilities and obligations incurred by said Trustees and * * * generally any and all liabilities and obligations with respect to claims of any character whether heretofore or hereafter asserted arising out of the possession, use or operation of the debtor's properties by said Trustees, or their conduct of the debtor's business, including liabilities and obligations hereafter arising up to midnight December 31, 1944." (1713)

Here the plan of reorganization had been prepared, approved by the court and affirmed by the Supreme Court, before the notion of saving taxes by use of plaintiff's loss was ever conceived. Although the notion was conceived later in 1943, it remained a "mere speculation of a possibility" by tax counsel until January 1944, when defendant first decided to make use of plaintiff's loss (see p. 17, supra). In the meanwhile the plan was approved by the creditors and confirmed by the bankruptcy court, in October 1943, and thus had already become effective to fix the rights and legitimate expectations of the defendant, its creditors and security holders.

Defendant emerged from the reorganization with the just obligation to pay its taxes and with more than ample funds to do so over and above any assets needed for the purposes of the plan. Enjoying all the benefits of the drastic features of the plan, the defendant Company, its new stockholders, and those investing in its securities, as well as the court, all expected it to pay its taxes. The statements issued by defendant to the public disclosed the contingent tax liability and the existence of $10,100,000 of

reserves in government bonds set aside to meet it. No one supposed—no one would have had a right to suppose—that the defendant would escape this liability by appropriating what belonged to another.

If plaintiff is denied recovery in this case, the new owners of defendant will not only have taken ownership of the company from plaintiff (as the plan contemplated), thereby inflicting a $75,000,000 loss, but they will also have taken from plaintiff, now an economic stranger already impoverished for defendant's benefit, plaintiff's tax credits resulting from that loss to enrich their position by an additional $17,000,000, something never contemplated by the plan.

The trial court argues that, since a judgment would be paid out of earnings,[27] plaintiff is seeking to share in defendant's earnings (273) and that the Supreme Court's affirmance of the reorganization plan denied to plaintiff that right by divesting it of stock ownership.

Suppose that defendant had discharged its tax liabilities with cash taken from plaintiff. Or suppose that the rolling stock used by defendant Operating Company had been owned by plaintiff and leased to defendant, and defendant seized it outright. A plan of reorganization holding, as this plan did, that plaintiff's stock ownership was worthless would cut off plaintiff's right as a stockholder, but it would not transfer to defendant the rolling stock, and it could not if it would (*Callaway v. Benton,* 336 U.S. 132; *Benton v. Callaway,* 165 F.2d 877, 882.[28]) If, then, the defendant took the rolling stock, would it be exonerated from duty to pay for it? Forsooth, it could be said that if the defendant repaid the cash taken to pay its taxes or if it paid for the rolling stock, it would do so out of its "earnings." An argument that, if

[27] Apparently the court had in mind that the reserves were set aside from earnings.

[28] "A solvent corporation, which has appeared specially as creditor and lessor in a reorganization proceeding, cannot be constitutionally compelled against its will to convey to the debtor a larger and better title than was granted in the lease."

plaintiff received a judgment for its cash or for the value of its rolling stock, it would be "circuitously" sharing in the earnings despite denial of that right by the Supreme Court would be a mere play on words. So it is here.

Nor can defendant's appropriation of plaintiff's rights be justified by the "philosophy" of Section 77 of the Bankruptcy Act, or by the view, as suggested in the trial court's opinion, that the purpose of the plan of reorganization to resuscitate the railroad will somehow be impaired by a judgment for plaintiff. That suggestion lacks justification in law as well as substance in fact. It could be said, in the example given above, that the rolling stock was necessary to resuscitate defendant. Yet it would not for that reason be exonerated from the duty to pay for it. With equal justice and reason defendant could forfeit the interests of the banks that now own title to the new Zephyr trains. This too, by relieving defendant of the duty to pay its just obligations, would no doubt better assure its stability and success. It would also be unjust. But it would be no more unjust than denial of relief to plaintiff here.

The plan did not contemplate that the reorganized defendants would emerge from bankruptcy with any surplus at all. But due to huge wartime profits it emerged with an unappropriated earned surplus of nearly $30,000,000 (see p. 28, supra). The capital structure fixed by the plan was devised by the Interstate Commerce Commission so that the reorganized Company would be able to pay a dividend of $3.00 per share per annum out of the income it could reasonably expect to earn. But in 1943 the company earned enough to pay $27.99 per share of common stock, after setting aside the $7,100,000 tax reserve, or $50.24 before setting aside the reserve, and in 1942 it earned $20.28 per share. (2179 a 2189, 2190 D 23 A, par. 11f and 12)

During the trusteeship $30,000,000 of operating revenues were used for additions and betterments, and another $6,000,000 of operating revenues were used to replace old equipment (see p 28, supra). After all this, the remaining income from the effective date of this plan until December 31, 1943 was sufficient

to meet all bond interest and to make all payments into the capital fund and sinking fund required by the plan, and still leave $20,658,938 (see p. 28, supra).

A judgment for plaintiff, which equity requires, will take from defendant nothing that it would have had if it had filed separate income tax returns and paid its taxes in cash, as the court below believes it should have done.

The real "paradox" in this case is the astounding fact that the capital stock of a subsidiary, decreed to have become and to be worthless in 1943, actually earned in the period January 1, 1942 to April 30, 1944, net income taxable on a separate basis in an amount in excess of $21,000,000.

This Court could not agree that the stock was worthless (*In Re Western Pac. R. Co.*, 124 F.2d 136 (9 Cir.)). It was overruled by the Supreme Court. But that fact, while rendering unassailable the judicial divestiture of plaintiff's ownership of defendant, does not render the defendant immune from the duty to account for the value of other rights of the plaintiff which it seized after the consummation of the plan of reorganization—rights which were not in existence until after the plan was consummated—to the further enrichment of defendant and its new owners in the sum of $17,000,000.

CONCLUSION

It is submitted that the judgment should be reversed. And since all the facts are before the Court, it is further submitted that the District Court be directed to enter judgment for plaintiff for the sum of $17,201,739, to be paid to appellant Alexis I. duP. Bayard, Receiver, for ultimate distribution to the stockholders of plaintiff Corporation.

Dated: San Francisco, September 13, 1950.

Respectfully submitted,

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(Appendices follow)

APPENDIX ONE

In the Report of the Senate Finance Committee (70th Congress, 1st Session, Senate Report 960), quoted in *J. D. & A. B. Spreckels Co. v. Commissioner,* 41 B.T.A. 370, the following appears (p. 8):

"* * * The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. Unless the affiliated group as a whole in the conduct of its business enterprise shows net profits, the individuals conducting the business have realized no gain. The failure to recognize the entire business enterprise means drawing technical legal distinctions, as contrasted with the recognition of actual facts. The mere fact that by legal fiction several corporations owned by the same stockholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit. To refuse to recognize this situation and to require for tax purposes the breaking up of a single business into its constituent parts is just as unreasonable as to require a single corporation to report separately for tax purposes the gains from its sales department, from its manufacturing activities, from its investments, and from each and every one of its agencies. It would be just as unreasonable to demand that an individual engaged in two or more businesses treat each business separately for tax purposes." (374)

Vol. 69, Congressional Record, p. 653, contains the following discussion:

"Mr. Tilson. * * * Let us remember that the provisions of the bill are applicable only where corporations are, in effect, but one corporation, 95 per cent ownership being required. In most cases there is an ownership of 100 per cent. The interests are the same.

"The ability to pay must be governed by the net income of the entire group. Computing the income of each separate corporation is but the basing of an income tax upon paper profits. Our income tax law should be based as nearly as possible upon income actually realized.

"Group organization of corporations, all owned ultimately by the same stockholders, has been developed by modern business for perfectly legitimate reasons, among them being separate accounting for the various parts of an enterprise and the desirability, and frequently the necessity, of creating an independent corporation for the purpose of carrying on a particular part of the business, both at home and abroad. The mere fact that by a legal fiction these are separate entities should not obscure the fact that they are in reality one and the same business, owned by the same individuals, and run as a unit. To refuse to recognize this fact and to compel for tax purposes the breaking up of a single business into its constituent parts is just as unreasonable as to require a single corporation to report for tax purposes the net result of its sales department, the net profit or loss on its manufacturing activities, the net profit or loss on its investments, or the net profit or loss on each and every one of its agencies. Such a requirement would be so absurd as to appear on its face ridiculous, and it is only necessary to state the case of a single corporation to demonstrate its absurdity. It is no more absurd, however, when applied to the different departments of a single corporation than it is when applied to the subsidiary corporation of a single unit. For instance, if a single corporation has a manufacturing department and a sales department, and we regard it as absurd to separate them for tax-accounting purposes, it is equally absurd when dealing with two subsidiary corporations, one of which does the manufacturing and the other one of which does the selling, to claim that theoretically they are two separate entities, when as a matter of fact, they are both engaged in a common, inseparable enterprise."

aforesaid, including specifically three suits in which the Corporation is beneficially interested, now pending in the Courts of the United States as follows:

(1) A case in the District Court of the United States for the Northern District of California, Southern Division, herein referred to as the Accounting Action for an inter-party equitable accounting respecting federal tax savings of approximately $17,500,000 resulting from the use of tax credits belonging to the Corporation in consolidated income and excess profits tax returns for the period January 1, 1942 to April 30, 1944, alleged to be wrongfully withheld from the Corporation by the Western Pacific Railroad Company, a corporation of the State of California.

(2) A case in the same Court to enforce payment of an indebtedness alleged to be due from Sacramento Northern Railway, a wholly-owned subsidiary of said Western Pacific Railroad Company.

(3) A case in the United States District Court for the Southern District of New York in which the Corporation has filed a third party complaint under Rule 14 of the Rules of Civil Procedure asking rescission of a certain transaction alleged to have been induced by fraud of the James Foundation of New York, Inc., one of the parties to said cause.

In addition to these three proceedings in which the Corporation is directly interested, it is indirectly interested in an Informer's Action commenced in the United States District Court for the Northern District of California, Southern Division, on February 24, 1950, in the name of the United States by S. Roberts under 31 U. S. C. A. Section 231 to 235 to recover—one-half for the United States and one-half for himself—double the amount of the tax savings involved in the equitable Accounting Action first above mentioned.

Your Receiver has given precedence to the equitable Accounting Action, and is a party of record therein. He has appealed from the judgment of the District Court in the Accounting Action but has taken no steps in respect to either of the two last mentioned suits in which the Corporation is directly interested. The Receiver is advised, however, that both suits as concerns the right of the Corporation to money judgments are meritorious.

2. Your Receiver reports that payment of claims of creditors and a return of any capital to stockholders of the Corporation is contingent on the successful prosecution of one or more of the several causes of action outlined above and in the absence of other than nominal cash assets, your Receiver, with the approval of this Court, has not complied with paragraphs (1), (2) and (3) of Rule 151 of the Court of Chancery, and has not filed an inventory of the receivership estate together with an appraisal thereof, a list of the debtors and creditors of the Corporation or a list of the stockholders of said Corporation. It is proposed by your Receiver to seek the approval of this Honorable Court to extensions of time as to full compliance with Rule 151 of the Court of Chancery until recovery has been gained in one of the pending suits and a fund thereby created for payment of creditors and distribution to stockholders.

3. Your Receiver reports that the Corporation has approximately 4,600 stockholders, Preferred and Common, living throughout the United States, of which more than 000 reside in the State of California whose original investment appeared on the books of the Corporation in the sum of $125,000,000, of which $75,000,000 was invested in voting stock of the Western Pacific Railroad Company. It was organized originally to acquire the stock of Western Pacific Railroad Company and voting stock in the Denver & Rio Grande Western Railroad Company. A half interest

sions in the law also eliminated the tax paid in 1942, for which a refund claim was filed March 9, 1945, as well as the tax for the first three months of 1944, for which returns were filed June 15, 1945.

There was always a substantial question whether consolidated returns were admissible for the period subsequent to October 11, 1943, when economic unity between the Corporation and its subsidiary, The Western Pacific Railroad Company had ceased: a question serious enough to justify the settlement under which the Government retained, and the Corporation relinquished its refund claim for, the $4,144,828 paid for 1942. The entire consolidated group being relieved of all tax liability by reason of the use of the Corporation's deductible loss, the reorganized Railroad Company, the principal defendant in the Accounting Action, was left in possession of $17,201,739 as the amount saved by resorting to consolidated returns instead of separate returns and under the finding of Judge Goodman this is the fund involved in the Accounting Action.

The question whether this fund belongs in equity and good conscience to the Corporation or to the defendant Railroad Company is made neither more nor less difficult of true solution by the fact that the amount is greater than the amounts with which Courts are ordinarily called upon to deal; it is in fact appreciably less than the face of the judgment with which this Court is familiar, $22,104,515.92 rendered by District Judge Welsh in *Overfield* v. *Pennroad Corporation,* and not greatly in excess of the amount, $15,000,000 finally paid in the litigated settlement of that case approved by this Chancery Court and on appeal by the Supreme Court of Delaware in *Perrine, et al.* v. *Pennroad Corporation, et al.,* 47 Atl. 2nd, 479.

To determine judicially the validity of one and the invalidity of the other of the conflicting claims to the fund

asserted by the Corporation and by its subsidiary, the Western Pacific Railroad Company, requires knowledge of the history of, and an understanding of the reasons for, the provisions of the Internal Revenue Code authorizing consolidated returns.

Consolidated returns were first introduced into the federal Income Tax Law by the Commissioner of Internal Revenue by a Regulation under the Revenue Act of 1917. This Regulation was broadened and given express sanction by Section 240 of the Revenue Act of 1918 being then made mandatorily applicable both to income tax returns and to excess profits tax returns; and this continued to be the law until 1921 when the filing of consolidated returns was left optional. There was, however, a gradual transition from the original concept of a duty to file consolidated returns resting upon the taxpayer to the ultimate notion now prevailing that the filing of federal tax returns on a consolidated basis is a privilege extended to the parent of a multiple incorporated enterprise for which there should be paid a premium. Except in the special case of railroad corporations where multiple incorporation was ordinarily an unavoidable requirement of state laws no provision for consolidated returns is to be found in the federal tax laws between 1934 and 1940 when the privilege was restored as to income tax returns. In 1942 the law was again broadened, having been extended to excess profits returns by the Revenue Act of 1942—subject, however, to the payment for the privilege of an additional tax increased from ¾ of 1% to 2%.

In the same year there was introduced into the Internal Revenue Code the new Section 23 (g) (4) providing that stock in a corporation affiliated with the taxpayer shall not be deemed a capital asset so that a loss resulting from the worthlessness of such stock acquired the character of an

operating loss credit deductible in the determination of taxable income.

Thus, continuously over a period of more than twenty-five years which included the economies of two World Wars there has been in the Internal Revenue Code, although for a part of the time only for railroad corporations, an authority for the filing of consolidated returns when there was the intercorporate unity inhering in 95% stock ownership; and in that long period the reason for the legislation showing the underlying intent of Congress has been so frequently reiterated that it is now crystallized in the text of the Treasury Regulation 104 which states:

> "Consolidated returns are based upon the principle of levying the tax according to the true net income of a single enterprise, even though the business is operated through more than one corporation."

Hence, whenever there exists the requisite stock ownership which has never been less than the present 95% minimum (5% less than all so as to permit beneficial ownership of directors' qualifying shares) the members of such affiliated group of corporations are accorded the privilege of pooling their incomes and pooling their tax credits and of paying federal taxes upon the excess, if any, of the pooled income over the pooled tax credits at the then current tax rate plus the additional 2% exaction for the privilege of resorting to the consolidated basis of accounting. If there is no such excess there is no tax and it was the clear intent of Congress that there should be none. Total Congressional forbearance came into play whenever the combined tax credits of the combined group exceeded the gains of the income producing members.

The tax credits which determine the existence or non-existence of tax liability differ in character and take a

variety of forms. In the years to which this controversy relates they included various specific exemptions, bad debts, amortizations, foreign and state taxes, unused operating losses and excess profits credits carried forward from prior years; and under Section 23 (g) (4) a current loss with carry-over and carry-back application resulting from the worthlessness of the corporate stock of any affiliate.

It would be inconsistent with the scheme and technique of consolidated returns ever to divorce the tax benefits from the unity of ownership which gives rise to them or to assume that Congress intended any benefit to any interest or tax paying entity other than the common parent corporation. This is recognized by the Securities Exchange Commission in exempting from the restraints upon inter-corporate transactions between utility corporations subject to the Utility Holding Company Act of 1933 those covered by its Rule U-45 (b) (6), which specifies:

> "A loan or extension of credit or an agreement of indemnity arising out of a consolidated tax return filed by a holding company (or other parent company) and its subsidiaries: *provided*, that the top company in the group assumes primary responsibility for the payment of any tax liability involved *subject to the right of contribution* (italics supplied) from the several members of the group in an amount not exceeding as to any company that percentage of the sum of the normal tax, surtax and excess profits tax on a consolidated basis which the sum of the normal tax, surtax and excess profits tax of such company if paid on a separate return basis is of the aggregate amount of normal surtax and excess profits taxes of the individual companies based upon separate returns."

It is not questioned by the Western Pacific Railroad Company, nor by the Commissioner of Internal Revenue

and indeed is apparently not questioned by District Judge Goodman that during the full period January 1, 1942 to October 11, 1943 the Corporation, as the common parent corporation, was the owner or was in a connected chain of ownership of at least 95% of all classes of stock of all of the other defendants or that the Corporation and the parties defendant in the Accounting Action were during all of that period properly affiliated within the letter of Section 141 of the Internal Revenue Code and Section 104 of the Treasury Regulations under which the consolidated returns for those periods were filed. Nor is it asserted that any requirement of subdivision (b) defining affiliation was not fully met.

The fact that during those periods the Corporation's principal subsidiary, the Western Pacific Railroad Company, was in trusteeship under Section 77 of the Bankruptcy Act is not of consequence as affecting or impairing its right as subsidiary to join with its common parent corporation and other affiliates in filing consolidated returns. Its right so to join and to be included, notwithstanding bankruptcy, is expressly recognized and provided for by Section 52 of the Internal Revenue Code and by Subdivision (c) of Treasury Regulation 104, Section 23.15. In passing it may be noted and perhaps emphasized that the last mentioned subdivision imposes an important limitation similar to that embodied in SEC Rule U-45 (b) (6) upon the accounting liability of an affiliate which is in bankruptcy. The liability of such an affiliate under a consolidated return is limited to what it would be if it had filed a separate return.

In the opinion of your Receiver, Congress intended—and clearly expressed its intention—that the Corporation's loss under the circumstances here disclosed might properly be used as *currency* to discharge, *subject to the right of equitable contribution,* the tax liabilities of the Corporation

and all of its statutory affiliates; and such was the expert judgment of the Commissioner of Internal Revenue. But, if the Commissioner of Internal Revenue erred in attributing such an intent to Congress it is difficult to understand what equitable principle permits Judge Goodman to convert the Commissioner's error into what he recognizes to be an "amazing and undeserved" windfall for the reorganized Western Pacific Railroad Company.

To state the Receiver's position concretely and in technical language: in an Accounting Action in equity between the Corporation and its affiliates in the period January 1, 1942 to October 11, 1943, for the value of a tax credit belonging to the Corporation and accepted by the Commissioner of Internal Revenue as the equivalent of money in the discharge of an individual tax liability of its subsidiary, the Western Pacific Railroad Company, in the amount of $17,201,739 the subsidiary Railroad Company is estopped to assert in resisting accountability to the owner of the tax credit that the Commissioner of Internal Revenue accepted valueless currency under a mistake of law.

If the Corporation as the common parent being in ample funds had discharged its subsidiary's individual tax liability of $17,201,739 by the use of money there would be no question that the subsidiary would be accountable to it for the money so paid.

This is clear on principle and is established by authority.

The well considered case of *Bankers Trust Company* v. *Florida East Coast Car Ferry Company*, 92 F. 2d (5th Circuit) so holds. This case arose as the result of the filing of federal consolidated income tax returns under which a tax credit belonging to one affiliate was applied to discharge a tax liability of another affiliate. A federal Receiver appointed for the affiliate whose tax credit has been so used sued for an accounting from the affiliate whose

tax liability had been so discharged; and reimbursement was awarded.

On principle that case is an indistinguishable authority in support of the Corporation's position in the present case.

If it be argued that the case is distinguishable because the tax credit there used was a money credit whereas in the present case the tax credit was a deductible loss, a negative thing having no actual value, the answer is that under the Internal Revenue Code the Corporation's tax credits including its deductible stock loss are made the equivalent of money for the discharge of the tax liabilities of the defendant Railroad Company for which they were employed.

Why should the subsidiary Railroad Company be free from accountability to its parent because instead of using money something else was used which for that particular payment Congress had ordained should be the equivalent of money? Why should the subsidiary Railroad Company even be interested in what currency was used so long as its tax liability was fully and completely discharged by what was used?

The obvious answer to these questions is supplied by the *Shreveport Bank Cases: Commercial Nat. Bank in Shreveport* v. *Connolly et al.* (176 F. 2d, 1002) and prior cases cited in footnote I to the opinion of Circuit Judge Waller. To avoid unduly extending this opinion and report it will be sufficient here merely to state that these cases hold the defendant liable to account to the plaintiff for tax savings realized by it through the use of a tax credit belonging to the plaintiff which was "a negative concept" (again to quote Judge Goodman) and of no value to the plaintiff but was of value to the defendant in enabling it to effect a tax saving of $190,000.

Ordinarily the action of all of the subsidiaries joining in consolidated returns is dictated by the common parent

corporation as the dominant stockholder and hence controversy is rare.

Where, as in the present case, there has been a subsequent change of proprietorship which deprives the common parent corporation of control of the action of the former subsidiary and of power to require to be done that which ought to be done to avert frustration of the intent of Congress, a court of equity may properly require through its traditional Action of Accounting that parties to a consolidated tax return make all inter-corporate adjustments and transfers necessary to give effect to the intent of Congress. The simple fact is that a sum of money with which Congress had a right to deal and which happens to be a very large sum of money is in the possession of a party to a consolidated tax return where Congress did not intend it to be. In this situation there can be no reasonable doubt of the power, and (the Receiver confidently asserts), of the duty of a court of equity, a tribunal constituted for the very purpose of dealing constructively and justly with unexpected and unusual situations, to require that the money be put where it equitably belongs and where Congress intended.

The Receiver finds no substance in Judge Goodman's implication that the Accounting Action based upon what was done administratively by the Trustees in accordance with Section 52 of the Internal Revenue Code is an attempt on the part of the Corporation to secure "an interest in the debtor" cut off by the reorganization decree. Actually the very web and woof of the Corporation's equity asserted in the Accounting Action is the Corporation's *loss* of all interest in its former subsidiary—an equity rooted in the very reorganization decree to which the Corporation gives full faith and credit but which Judge Goodman believes the Corporation is trying to circumvent.

Where the cardinal error in Judge Goodman's opinion lies is in his failure to recognize that the Corporation's Accounting Action has nothing to do with the reorganization decree but arises out of relationships created by and equities and accountabilities flowing from the filing of consolidated returns—all of these being obligations which the reorganization decree required the Reorganized Company to assume and discharge under the Assumption Agreement. The Assumption Agreement embraces "generally any and all liabilities and obligations with respect to claims of any character whether heretofore or hereafter asserted arising out of the possession, use and operation of the debtor's property by said trustees or their conduct of the debtor's business including liabilities and obligations hereafter arising up to midnight December 31, 1944."

The Receiver finds nothing unusual about this case except the large sum of money involved. To summarize events:—The tax law provided for consolidated returns and Section 23 (g)(4) permitted any affiliate (including of course the Corporation and parent) to set off a stock loss against operating profits, instead of capital gains as theretofore. The Interstate Commerce Commission held the Corporation's stock in its subsidiary valueless although at the time October 1943 the stock was currently earning large sums of money. The stock of the operating subsidiary became valueless in October 1943, when there was no longer any chance for the Corporation to obtain the economic benefits of ownership and control; and in the final tax settlement the Government obviously balanced off the sum it might have collected by litigation, taxes from October 11, 1943 through April 1944, by retaining the sum previously paid but for which the Corporation had filed a valid refund claim. The Trustees of the bankrupt affiliate were expressly permitted to join in the consolidated

returns and by doing so brought the bankrupt affiliate into the group and subjected it to group treatment and inter-company accountability and the reorganized Company succeeded to its accountability under the all-inclusive Assumption Agreement.

For all these reasons the Receiver is of the opinion that the Court of Appeals will protect the position of the Corporation.

7. In the event of recovery in the Accounting Action, your Receiver will request that the amount thereof be paid directly to him, so that it may be disbursed under the supervision of this Honorable Court to the stockholders of the Corporation, after payment of all proper creditor claims and charges of this receivership.

And your Receiver will ever pray, etc.

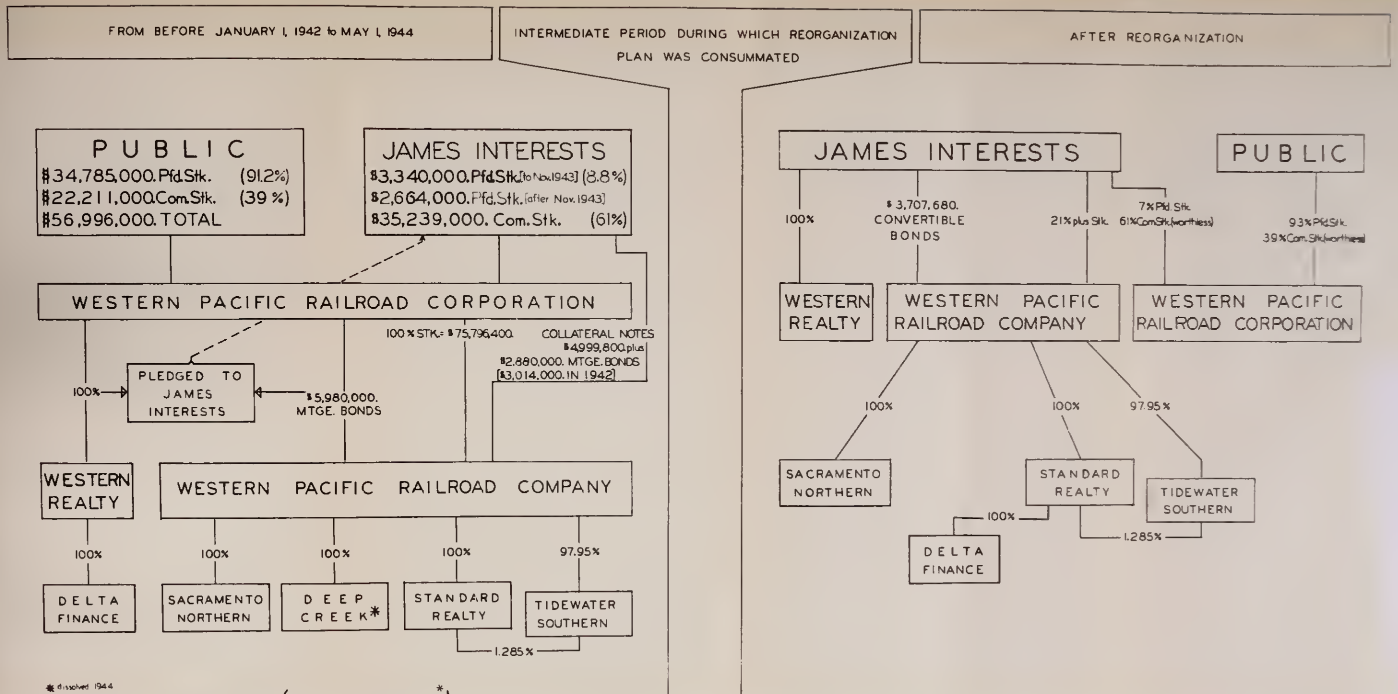
Respectfully submitted,

Alexis I. duP. Bayard
Receiver of the Western Pacific
Railroad Corporation

This Is To Certify that the foregoing is a true and correct copy of a preliminary report filed this date by Alexis I. duP. Bayard, Receiver of The Western Pacific Railroad Corporation, in compliance with an order of the Vice Chancellor entered on April 19, 1950.

John E. Babiarz
Register in Chancery

Dated: May 15, 1950.



P. Ex. 1 (As Corrected*)

* P. Ex. 1 inadvertently showed Delta Finance as dissolved in 1944, whereas it was Deep Creek that was dissolved.

POSITIONS HELD BY OFFICERS, DIRECTORS AND COUNSEL OF THE W.P.R.R. CORPORATION WITH W.P.R.R. COMPANY AND TRUSTEES, THEIR COMPENSATION AND SOURCE THEREOF DURING THE PERIOD JUNE 1, 1943 TO OCT. 10, 1946.

Name	CORPORATION	COMPANY and TRUSTEES	Compensation
WHITMAN, RANSOM, COULSON & GOETZ (ROBT. E. COULSON & JAMES K. POLK)	TAX COUNSEL	TAX COUNSEL DIRECTOR (Coulson) from 12-28-44 COUNSEL for REORGANIZATION COM. MEMBER REORGANIZATION COM. (Coulson) to 3-28-46	TOTAL OF $149,325
SCHUMACHER	DIRECTOR	CH. EXECUTIVE COM. to 12-28-44 DIRECTOR to 12-28-44 TRUSTEE to 12-31-44	PENSION from 5-1-45 $15,000. PER YEAR From 5-1-45 $3000 PER YEAR
CURRY	PRESIDENT TREASURER DIRECTOR	DIRECTOR & EXEC. COM. to 11-20-44 VICE PRESIDENT & ASST. SECT. & ASST. TREASURER to 4-30-45	PENSION from 5-1-45 TO 5-1-45 $11,700. PER YEAR From 5-1-45 $3000 PER YEAR
VALOUCH	VICE PRESIDENT & SECRETARY & DIRECTOR from 5-1-45 Secretary to Curry	Secretary to Schumacher & Curry ASSISTANT SECRETARY 12-4-44 to 4-30-45	Between $2640. & $2860. PER YEAR to 5-1-45.
SHEEHAN	DIRECTOR 2-15-44 to 10-10-46	SWITCHBOARD OPERATOR & RECEPTIONIST to 5-1-45	Between $1980. & $2344. PER YEAR
WIENKEN	SECRETARY to 5-1-45 DIRECTOR to 4-25-46	STENOGRAPHER to 5-1-45	Between $2880. & $3212. PER YEAR
PIERCE & GREER (NICODEMUS & CAMPBELL)	GENERAL COUNSEL DIRECTOR (Campbell) to 5-1-45	COUNSEL to 12-31-45	TOTAL OF $19,625.
OSBORN	DIRECTOR	DIRECTOR & EXEC. COM. to 11-20-44	
WOOD	DIRECTOR		
HATTON	DIRECTOR		

CLERK-DENVER RIO GRANDE WESTERN R.R. CO. IN OFFICE JOINTLY OCCUPIED WITH WESTERN PACIFIC R R CO

P. Ex. 2A.